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# SMALL BUSINESS ADMINISTRATION'S DIRECT LOAN PROGRAMS

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HEARING  
BEFORE THE  
COMMITTEE ON SMALL BUSINESS  
UNITED STATES SENATE  
NINETY-SEVENTH CONGRESS  
FIRST SESSION  
ON  
SMALL BUSINESS ADMINISTRATION'S DIRECT LOAN  
PROGRAMS

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OCTOBER 27, 1981



Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE  
WASHINGTON : 1982

88-220 O

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## **SMALL BUSINESS ADMINISTRATION'S DIRECT LOAN PROGRAMS**

**TUESDAY, OCTOBER 27, 1981**

**U.S. SENATE,  
COMMITTEE ON SMALL BUSINESS,  
Washington, D.C.**

The committee met, pursuant to notice, at 9:35 a.m., in room 424, Russell Senate Office Building, Hon. Lowell P. Weicker, Jr., chairman of the committee, presiding.

Present: Senators Weicker, Dixon, and Danforth.

Also present: Robert J. Dotchin, staff director; R. Michael Haynes, chief counsel; John G. McLean, professional staff member; Alan L. Chvotkin, minority chief counsel; Charles Smith, staff of Senator Dixon; and Margaret M. Broadbin, hearing clerk.

### **STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, COM- MITTEE ON SMALL BUSINESS**

Senator WEICKER. Today the Small Business Committee will hold an oversight hearing on the Small Business Administration's direct lending program. This program, although cut drastically by the reconciliation bill, still accounts for a major portion of the agency's funds and resources.

Since taking over the chairmanship of this committee in January, I have repeatedly said that one of the top priorities of the committee is to maintain aggressive oversight of the SBA and its programs. We have already held hearings highlighting problems in a number of areas in the Small Business Administration. These have resulted in program changes and hopefully will bring about a general tightening up of the agency overall. The hearing today is another step along that road in demanding accountability of taxpayers' dollars.

I might add that Senator Dixon personally requested that the committee hold this hearing, and he has been instrumental in putting it together. So I would like to take this opportunity to commend him for his leadership role in this area and his invaluable assistance.

Senator Dixon?

### **STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM THE STATE OF ILLINOIS**

Senator DIXON. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you and the ranking member for agreeing to my request for today's hearing. I sought your concurrence for this hearing after I carefully reviewed the series of nine

articles which appeared in the St. Louis Globe-Democrat regarding the direct loan program of the SBA.

The purpose of this hearing is to provide our committee with a range of opinions on the successes, the failures, the problems, and the potentials of the direct loan program. I recognize that unfortunately we have not had an opportunity to do an exhaustive investigation of the direct loan program in the 4 short weeks since I met with you. This hearing is a beginning, because the committee does recognize that it has a responsibility to the taxpayers, to small business men and women, and to the SEA to begin to analyze this major loan program.

Mr. Chairman, after reading the articles, it was obvious to me that the loan policies and management directions from past SBA administrations have not been all they could be. Mistakes arose, I think, from the belief that simply giving money to people to start or expand small businesses without providing oversight or any other continuing assistance was an efficient way to help.

There may be a need for a direct loan program, but I do not believe Congress can continue to allow the SBA to manage a direct loan program in the future the way it has done in the past.

Budget reductions, the state of the national economy, and the decline in our country's economic base have jeopardized the continuation of this program, unless the Small Business Administration takes the steps to change its policies—to be innovative and to examine local communities and discover their true business needs.

Today's hearing, Mr. Chairman, is not meant to provide the definitive answer to the problems of the direct loan program but rather to begin a closer examination of what needs this type of program can serve in the years ahead.

Thank you very much, Mr. Chairman.

Senator WEICKER. Thank you very much, Senator Dixon.

We have as our first witness our colleague from Missouri, the Honorable John Danforth.

I am aware of your interest and concern in this area, Senator. We are pleased to have you here.

#### STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator DANFORTH. Thank you, Mr. Chairman.

I compliment you on your prompt decision to hold hearings concerning recent reports which charge gross mismanagement of yet another program administered by the Small Business Administration. I appreciate the opportunity to testify today, though I am troubled by the events which make this hearing necessary.

Mr. Chairman, what we know of the problems associated with the direct loan program is due in large measure to the hard work of two reporters—Tom Amberg and Mike Montgomery—who work for one of the great newspapers in my State—indeed, one of the great newspapers in America—the St. Louis Globe-Democrat. Their recent series of articles, "SBA Loans: Fast Track to Failure," represents literally years of work—a nationwide investigation which took them over 17,000 miles to 15 States. Together they interviewed dozens of SBA officials and hundreds of loan recipients. More than 18,500 records of SBA loans were analyzed—over 26

percent of the SBA loans made across the Nation from 1970 to 1978. A reprint of their articles accompanies my testimony, and I ask that it be made a part of the permanent record.

Senator WEICKER. Without objection, it will be made a part of the record at this point.

[Material follows:]

St. Louis Globe-Democrat

Aug. 31-Sept. 9/1981

# SBA LOANS: Fast Track to Failure

By Thomas L. Amberg  
and  
Michael R. Montgomery

A nine-part investigation  
of the Small Business  
Administration's direct  
loan program.  
Reporters Amberg  
and Montgomery  
traveled more than  
17,500 miles inter-  
viewing 80 SBA  
officials and  
hundreds of loan  
recipients in  
15 states.

# Millions lost in SBA loans

## 42 percent of borrowers end up in default and out of business

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(First of a series)

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More than \$571 million in taxpayers' dollars has been lost as more than two of every five loans have ended in default in the federal government's primary program to help the underprivileged enter the mainstream of American business.

Rather than help the disadvantaged, as the program was designed to do, recipients often become its victims. The program often ends up putting people out of work, draining life savings and leaving a trail of closed shops and broke lives, hundreds of interviews have revealed.



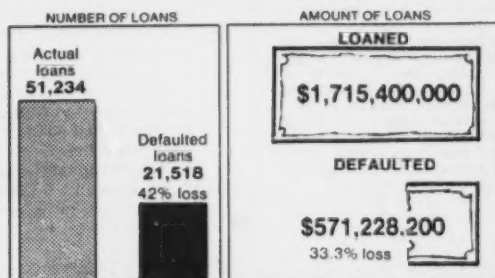
The high failure rate results in part from a pattern of making significantly smaller loans to borrowers in minority urban areas than elsewhere and a history of giving loans to totally unqualified people.

AFTER A long, intensive nationwide investigation, The Globe-Democrat found that lax policies and sloppy procedures in the Small Business Administration's direct business loan program from 1970 through 1978 have cost the federal Treasury \$571,228,200 — a figure that could reach \$900 million if losses in 1979 are consistent with previous years.

Across the country, many SBA officials interviewed said the program should either be scrapped or completely overhauled. The officials interviewed agreed the program has serious problems.

Loan recipients whose businesses failed were more outspoken. "I wish they'd never lent me the money; I'd have been better off," said one man. His comment was repeated time and time again by other borrowers across the nation.

### SBA loans/defaults\* (1970-78)



\* Projections based on 26.8 percent of all loans made.  
Source: St. Louis Globe-Democrat analysis of SBA internal documents.

"It's as if the money were soap and we're supposed to peddle it," said Bernard Lump, chief liquidation officer in the SBA's San Francisco district office. "It's not just a feeling I have; it's a fact. There is no respect for money in this agency. I'm appalled at this stuff. We're not helping these people."

THAT FEELING was echoed by Clyde Cromwell, an official in the Dallas district office. "I've gone back to a loan officer on occasion and said, 'What in heaven's name are you doing making this loan?' and he's said, 'Got to get the money out, man. You get no brownie points for declining a loan.'"

Added Denver District Director Chester B. Leedom, "We don't do a man any favors by putting him in business with an artificially low interest rate and without proper management ability."

In fact, the actual default rate within the program is masked by a widespread policy of granting deferments to loan recipients who have missed payments, artificially understating the losses. The purpose in granting the deferments is often to make a loan officer or district field office "look

good," SBA insiders said. Lump, who has served in SBA offices in New York, Los Angeles and now San Francisco, said, "I would say that, at any time, 10 to 25 percent of the direct loan portfolio would be in deferment status, which means we just stopped collecting money on those loans."

LUMP EXPLAINED that by deferring loan payments, loan officers are able to transfer the loan from delinquent status to a "current" status, thus making their portfolio appear to contain a greater percentage of good loans. That can mean more money and faster promotions for the loan officers because the agency has had an incentive program targeted largely on such things as high percentages of current loans, he said.

"I was part of the 'we' that did it," Lump declared. "I know. We were the No. 1 office in New York, and when I was in LA it was the same, but it was all a charade. It's just a way to hide the actual default and delinquency rates. People do it to protect themselves and get ahead."

When The Globe-Democrat informed SBA Administrator Michael Cardenas that it had



found a 42 percent default rate, Cardenas expressed no surprise, admitting that the program has been poorly handled for years. He said he intends to change the direction of the program but offered no specifics.

Asked what he felt was an ideal or reasonable default rate, he replied, "I'd like to see it no higher than 10 percent."

**THE DIRECT** loan program, set up in 1953, was expanded in 1964 and again in 1969 as a response to urban riots in the late 1960s. While there are several types of direct loans, the overall purpose is to enable marginally qualified borrowers to enter the free enterprise system by owning and operating their own businesses. The threshold requirement for receiving an SBA direct loan is to be turned down for the loan by at least two banks and not to qualify for even a 90-percent SBA-guaranteed loan.

The SBA generally requires a person (there is no formal policy) to put into the business whatever private money he has. The program is intended for anyone going into or expanding a business who is unable to obtain the money from conventional lending sources.

The Globe-Democrat investigation, which involved two years of litigation by the newspaper under the Freedom of Information Act, entailed the examination of more than 14,000 loans, thousands of other documents, hundreds of interviews and a computer-assisted study of loans and default records. It was based on an analysis of nine years of direct loans made in 16 SBA offices.

Analysis of the SBA loan data was accomplished by utilizing the specialized computer system and consultation services of Comshare Inc., an international computer services firm.

Among the findings:

- Of the 14,261 SBA loans made in the 16 district offices from 1970 through 1978, 5,948 — or 42 percent — have ended in default.

- In terms of actual dollars lost, \$157,535,380 — or 33.3 percent of the \$473,079,234 loaned during the period in the 16 offices — was never repaid.

- SBA attempts to collect on collateral or force payment from loan recipients through the courts are minimal at best, with the agency collecting about 18 cents on the dollar once a loan has been placed in liquidation, the first step in writing off the loan.

- Loans have been concentrated in small geographical areas marked by high unemployment and economic depression, yet within those areas the size of the loans made was significantly less than average overall. That pattern of relative undercapitalization gives weight to charges by dozens of minority loan recipients who told reporters they felt that heavily black areas were being given many of the loans to show "commitment" to the area, but that the loans were too small to allow a business to survive.

- The SBA has consistently understated its loss rate, never admitting in any year between 1970-78 more than a 10.8 percent loss rate to Congress. Congress' watchdog,

the General Accounting Office, has accepted as true and repeated with virtually no serious investigation the misleading loss rates.

- SBA officials repeatedly increased the risk by making loans to people unqualified to run the type of business for which they have received the loan. Examples found by reporters include a barber who received a loan for a grocery store, a potato chip salesman who received a loan to run a liquor store, a clothing store salesman who received a loan to run a restaurant and a

karate instructor who received a loan to set up an Oriental food store.

- There has been a substantial hardship for those who received loans but soon discovered they were in well over their heads. Not only were life savings often lost as would-be entrepreneurs tried to keep their businesses afloat, but in a number of cases, reporters found people whose family life have been thrown into confusion and disarray due to the strain of debts, bankruptcy or loss of credit.

- SBA officials failed to follow their own

## The story behind the Small Business Administration series

Billions of dollars have been spent through the Small Business Administration's direct loan program since 1953, but the agency refused Globe-Democrat requests for information on how many of those loans defaulted, leaving taxpayers holding the bag.

Concluding that the public's need for a meaningful evaluation of the program was not possible given the SBA's refusal to provide default information, The Globe-Democrat filed suit in 1979 under the federal Freedom of Information Act.

The newspaper eventually prevailed, and the first detailed data on SBA stewardship of taxpayer money was turned over to Globe-Democrat reporters Thomas L. Amberg and Michael R. Montgomery in June and July of this year.

More than 18,500 records — reflecting 26.8 percent of the SBA loans made nationwide from 1970 through 1978 — were statistically analyzed with the assistance of Michael Jones of Comshare Inc., an international computer analysis and consulting firm.

The records obtained from the SBA contained raw data with regard to the loans, and The Globe-Democrat was able to analyze the data down to types of businesses within individual ZIP codes throughout the country, average loan sizes, disparities in loan amounts between areas, and many other calculations. A number of sophisticated analytical techniques were applied to the records to obtain a detailed breakdown of the entire program.

Amberg and Montgomery then traveled more than 17,500 miles, interviewing more than 80 SBA officials and hundreds of loan recipients in 15 states to get a complete picture of the direct loan program.

Amberg, a prize-winning investigative reporter who has worked for The Globe-Democrat for 10 years, has a bachelor's degree in political science and earned a master's degree in business administration while working for the newspaper. Montgomery, who has a bachelor of science degree in administration, has reported extensively on local affairs.

standard operating procedures — in making and monitoring loans and minimizing losses stemming from defaults — “in a push to get the money on the streets.”

The high volume of loans and low rate of success within minority communities are exactly what the agency's regulations say should not happen. “From a socioeconomic viewpoint, the indiscriminate approval of loans at a high volume and low rate of success can do nothing but impair our relationship with the small business concerns and communities that we are attempting to help,” the SBA's own procedures manual says.

Elsewhere in the manual, another major

point is stressed: “Many loans are in liquidation solely because working capital requirements were not given adequate consideration.”

**SO DISORGANIZED** and troublesome is the program, in fact, that 11 of 16 districts and branch-directors interviewed in the 16 offices, said privately that the entire program should be either scrapped or significantly overhauled.

“If we got a telegram tomorrow from Washington saying the direct loan program was being stopped, everyone in this office would stand up and cheer,” said one Western district director.

Because of the large and representative

sample size — the 14,261 loans examined are 26.8 percent of the loans made by the SBA through 1970 through 1978 — the figures can be translated with statistical accuracy to reflect the national loss rate during the period, according to statistical experts.

In terms of dollars lost, the SBA default rate for the direct loan program is 33.3 percent, which means an actual loss of more than \$571 million from 1970 through 1978. In terms of numbers of loans, the default rate is 42 percent.

Later years were not included in the study because there has been insufficient time for the businesses to show a pattern of either success or failure.

# Loose practices lead to SBA's high failure rate

## Loans often made to businesses sight unseen

By **THOMAS L. AMBERG**  
and **MICHAEL R. MONTGOMERY**  
Globe-Democrat Staff Writers

(Second of a series)

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Through its loose lending practices and servicing procedures, the Small Business Administration virtually assures that its direct business loan program will have a staggering default rate, said dozens of field officials throughout the nation interviewed by The Globe-Democrat.



“It's not hard to see why there's such a horrendous failure rate for these businesses. It starts with a mentality that has no respect for the money it deals with,” one official said.

That official, San Francisco chief of liquidation Bernard Lump, recalled instructions given him by a former chief of finance in the New York City office. “He said, ‘Don't look at it as money. Look at it as numbers on a computer run. We call them loans, but they're really just grants.’”

Asked why the default rate is as high as it is — 42 percent of the direct loans made from 1970 through 1978 failed — and what can be done about it, SBA field officers who were interviewed raised these major points:

## Average caseload per loan officer



Source: Robert Morris Assoc.



Source: SBA Globe-Democrat graphic

● There is insufficient screening of applicants. “We lend money to whatever walks in the door,” Lump said. “We should try to target our money to certain industries the way banks do.”

Thomas Trimboli, district director in Phoenix, Ariz., said, “I'd like to see a more creative use of our direct loan money. Why not take most of the money and target it to

the types of businesses that the state or city or area needs to ensure that it generates economic development?”

Such targeting is not possible because the agency's rules require taking loan applicants in chronological order or a first-come—first-served basis, Trimboli said.

Loan recipients' lack of business experience is cited as “the greatest single reason” for loan failure by most SBA

personnel interviewed.

● Loans are made routinely without the loan officer or other SBA personnel even seeing the applicants' proposed or present place of business.

"Field visits are a MUST," Buffalo, N.Y., Branch Director Franklin J. Sciortino said. "You can't make a rational decision on a loan without a field visit. A picture's worth a thousand words, as the saying goes, and it's just amazing how much you can tell about a business in just a five-minute visit."

And yet, in every other office visited by reporters, officials conceded that field visits were not always made, and, in many cases, rarely made, because of a lack of personnel.

SBA's internal regulations require that field visits be made in all cases of direct loans to start a new business unless specifically waived by a loan officer's superior. The shortage of personnel to handle the crush of applicants — waiting lists extend up to 2½ years — makes waivers the rule and field visits the exception.

● SBA has for years marched out of step with the rest of the financial world. Its loans are made throughout the year regardless of financial conditions. "Lending is a cyclical business, and we should treat it that way," said Lump, of the San Francisco SBA office.

"When interest rates are high, we should be putting people into servicing loans, not making them, and when interest rates are low, the reverse should be true.

"But what happens is that SBA acts oblivious to the wishes of the Federal Reserve. When the Fed is trying to get banks and lending institutions to cut down on lending, the old SBA is right out there pumping more loans into its \$18 billion portfolio. It doesn't make the least shred of sense," he said.

● A major problem raised by several SBA field officials is the lack of specific requirements for the borrower to put his own money into the business. Although the SBA policy manual states that an "applicant must have a reasonable amount at stake in the business," there is no specific figure for private investment. The lack of a specific requirement for private equity by the applicant gives him little incentive to keep the business solvent, field officials said.

The chief financial officer in the Newark, N.J., district office advocated returning to the dollar-for-dollar matching concept used by the agency until the mid-1980s.

"You'd eliminate the type of situation where a couple of guys stand on a street corner one night and decide to go into business," he said.

Charles R. Hertzberg, director of the SBA's Office of Business Loans in the central office in Washington, said, "There was a weakening of the 7(a) loans (the

major part of the direct loan program) to coincide with the EOLs (Economic Opportunity Loans, which are intended to help minorities and have never required a certain amount of private equity from the applicant.)"

● A sample of 534 loan files from 16 selected SBA offices showed that 33 percent of the loans were made in part or in whole to pay off amounts owed by the businesses to private or public creditors and to pay local, state or federal taxes.

In those cases, an average of 46.4 percent of the loan was used to pay creditors. Many times, the entire loan was used, with SBA approval, to pay off a series of private creditors.

In one case, for instance, the Dallas district office loaned \$100,000 to a business that had failed six months previously. The loan went entirely to satisfy accounts payable, notes payable and a bank. The business (the Canton & Edgewood Concrete Co.) subsequently went out of business for a second and last time 3½ years later, with SBA losing about \$55,000.

SBA regulations, however, dictate that loan proceeds must not be used to "bail out" any "creditors who are in a position to sustain a loss."

● From the same sample of 534 loans, The Globe-Democrat found 52, or 9.7 percent, that went in part to pay off other SBA direct loans. By doing so, the agency understated the actual number of defaulted loans.

Once a loan is approved, eventual failure and loss to SBA is often assured through policies that, in general, fail to protect the loan, investigation showed.

Those policies — or sometimes lack of policies — include:

● A shortage of personnel to service loans. Servicing personnel are theoretically supposed to handle a host of administrative problems, such as any changes in accounts, as well as be available to make calls on businesses in need of special help and attention.

Because the direct loan program is by its nature made up of higher-risk individuals, those businesses generally require substantial attention. However, the average caseload in the 16 offices surveyed by Globe-Democrat reporters is 510 loan recipients per loan officer.

In contrast, loan servicing officers at commercial lending institutions generally have a caseload of 10 to 100 cases, according to banking officials.

A recent study by Robert Morris Associates, the national association of bank loan and credit officers, found the majority

of loan officers at commercial institutions handled no more than 99 loans. The average caseload was 103 loans per officer, according to the study.

Phoenix District Director Thomas Trimboli, discussing the high caseload, said, "The servicing people are not engaged in preventive management assistance; they're engaged in reactive management assistance."

Trimboli and other SBA field personnel complained that the lack of staffing makes it impossible for a servicing officer to do anything other than react to a crisis, not prevent one.

"Once the thing is failing, there's really nothing a government person or banker can do for it," said Lump, of the San Francisco office. "The bad decision was made in making the loan in the first place."

"Putting many of these people into business in the first place is like putting them in the ring with Muhammad Ali. Once they start to take a beating, there's not much we could do if we crawl in the ring with them," he said.

Another SBA official said, "It's pretty unrealistic to think a servicing officer can provide much real help when he has hundreds of firms to deal with."

● SBA fails to protect its collateral position in many cases. When a loan is made, the agency accepts certain collateral that is supposed to secure the loan. Often, the agency will later take a second position on the same collateral, thus allowing a commercial lender that comes along later to have first rights to the residence or business property and giving SBA whatever, if anything, is left over from a sale of that property.

"We don't protect our position," Lump said. "It's common. A guy starts going bad and wants more money, and if the agency won't give it to him, he goes out and gets it from a trust deed company. That company usually charges interest at prime (rate) plus five points, plus another 10 to 24 points (a point is 1 percent of the loan amount) on top of that for what's called loan origination fees."

"To make the loan, SBA has to agree to subordinate its position, and we do it as a matter of course. Absolutely. We do about two a day in San Francisco, and twice that in Los Angeles. It's rampant all over the country," Lump said.

Subordinating the loan position means that when the trust deed company forecloses (which almost always happens, according to Lump), SBA is left with no collateral return. "Millions go down the drain in that way," Lump said.



# How SBA loan cooked up restaurant failure

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(Third of a series)

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Merrill L. Moss, a self-described amateur cook with no experience in operating a restaurant, opened a posh eating establishment in St. Louis with \$150,000 of taxpayers' money and flopped less than six months later.



With all but \$5,996 lost, Moss closed the gourmet dining establishment at Fourth and Olive streets called Chez Jean Pierre, which had offered main meals from Coquelet Albufera at \$15 to Carre d'Agneau en Croute, the house specialty, for \$37.

Moss told The Globe-Democrat that from the beginning in 1978 he had no experience in the business "whatsoever" to back up his "glamorous" venture.

"YOU AND ALL other taxpayers paid for my failure," he said.

Moss' experience is one example of how the Small Business Administration — through poor procedures for making loans, monitoring them, and minimizing taxpayer losses when default occurs — has lost one-third of the \$2 billion it spent during the decade ending in 1979, a Globe-Democrat investigation has revealed.

The performance record of the St. Louis SBA office serving eastern Missouri is one of the worst in the nation, reflecting the failures of a program whose cost is much greater than the hundreds of millions of dollars lost through defaults, The Globe-Democrat investigation showed.

A rush to "get the money on the street," as one SBA official described it, has resulted in St. Louis officials making loans almost haphazardly to people who, by their own admission, were totally unqualified and inexperienced to run the businesses being financed at taxpayers' expense. As a result, almost six of every 10 loans of the 1,041 loans made here from 1970 through 1978 have ended in default.

Although the SBA's policy and procedures manual stresses that the management ability of the prospective borrower is a prime factor in considering an application, SBA officials have often given loans to people who were making major career changes without benefit of prior experience.

And, in many cases, the businesses were so short-lived or did so poorly that because of accruing interest and lack of payments, the SBA is owed more money than it loaned.

The loan failure rate here not only raises questions about the qualifications of the borrowers but the qualifications and procedures of SBA personnel as well.

The ill-fated venture of Chez Jean Pierre is one of many examples.

● On May 15, 1978, the SBA approved the \$150,000 loan to Moss to set up Chez Jean Pierre — despite the fact that, as Moss said, "I had no experience whatsoever. Nothing. I'm an amateur cook, and it seemed like a sort of glamorous concept."

A former advertising writes, Moss recalled the whole venture as a nightmare, with the bottom line being that he opened in November 1978 and closed less than six months later on May 1, 1979.

With SBA's blessing, he said, he had selected a "terrible location," had accepted a financing proposal that left him woefully short on working capital and got into a business he knew nothing about.

The cost to the SBA, and ultimately the taxpayers, was \$144,004 in principal and interest that the SBA has had to charge off. Moss filed for bankruptcy, and the debts were discharged by court order.

Today, living in Barnbridge Island, Wash., Moss said, "They would have done me a huge favor if they had turned down my loan and told me to go get some experience before I try it on my own."

Examples of SBA failures — in which 33.3 percent of the \$2 billion spent on the program from 1970-78 ended in default — are legion.

● From February 1970 to April 1971, the SBA here made three loans — the first for \$10,000, the next for \$25,000 and the third for \$65,000 — to Luther Boykins, a barber, to open Luther's Market, a grocery store at 4135 Shreve Ave. Six months after the final \$65,000 loan, the grocery shut down, Boykins went back to being a barber, and the SBA was left with \$79,183 still owed in principal and interest. That amount was subsequently charged off.

Boykins said he is bitter that the SBA even gave him the loan in the first place, because besides losing his life savings, he incurred a debt he said he will never be able to pay off.

"I was going to be a failure no matter what," he said. "The combination of a lack of experience and a lack of working capital doomed me."

The SBA did not inspect the stock or equipment, provided no advice on taxes, management or bookkeeping and offered no aid from SCORE (Service Corps of Retired Executives) volunteers, he complained.

He maintained that the SBA's direct loan program amounts to no more than "pacifying and satisfying" the black population, and is, in fact, "designed for black people to fail" because it sets them up in business without the proper experience or enough financing.

● When William J. Herbster applied for an \$8,000 SBA loan on May 2, 1972, he was a potato chip salesman on a truck route. Nine days later, when his loan was approved, he was the new owner of the Driveway Liquor store at 4114 Jennings Road, Jennings. Five months later, he was out of business, leaving the SBA with \$8,463 in principal and interest to charge off as another bad debt.

Herbster remembered that he "went down to see the man at SBA (to ask for a loan), and it was all real quick. They gave me the money right away," despite, he said, his lack of experience.

● In another case, M.C. Skinner, with a background of 20 years in retail clothing sales, was given \$32,400 in loans to turn a deserted gas station on the city's North Side into a diner.

Although SBA officials suggested Skinner might look into the idea of his own clothing shop, he insisted it was "a dying business," he said, and remained set on the idea of his own diner.

Skinner received a \$29,400 loan from the SBA in December 1978 and another \$3,000 loan in September 1979.

After 14 months of delays, occasioned in part by misinformation from SBA officials, Skinner said, he finally opened his restaurant at 2914 Parnell Ave. in February 1980. But the business went bust in September 1980, leaving Skinner with no diner, no credit rating and the loss of at least \$2,500 of his own money.

The SBA, and taxpayers, were out a total of \$34,566 in principal and interest.

● One West End restaurant at 5897 Delmar Blvd. with the catchy name of Tak-It-An-Gitt received a loan in 1971 for \$10,500. Today, the SBA has long since written off the loan, with Tak-It-An-Gitt still owing \$10,471.88 in principal and interest. The interest stopped accruing in 1976 when the loan was written off. Globe-Democrat efforts to reach the owners were unsuccessful.

● When auto mechanic Franklin Williams "was looking around for something to do" in Philadelphia in 1971, he and his cousin, Dillard Mosley, a salesman for Sears Roebuck and Co., thought opening a hardware store would be a good idea. He told The Globe-Democrat that he and his cousin put together some projections ("we didn't exactly know what we were doing") and presented them to the SBA.

SBA thought the idea was a good one, and without changing anything in the

**INTENTIONAL  
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projections, gave Williams \$50,000 to buy Feldman's Hardware Store.

"The projections were way, way off," Williams said. "We knew we were in trouble within a year. The store lasted 3½ years." He said he is again working as a truck mechanic and his cousin is "somewhere out West."

● Ye Mo Ahn was a karate teacher in 1975 when she decided that "the karate

wasn't going so good." Some friends told her that they thought "an Oriental food store would go good, so I tried it." With no managerial experience, she could only keep the store afloat 1½ years on the \$30,000 SBA loan before "too much competition" killed the business," she said.

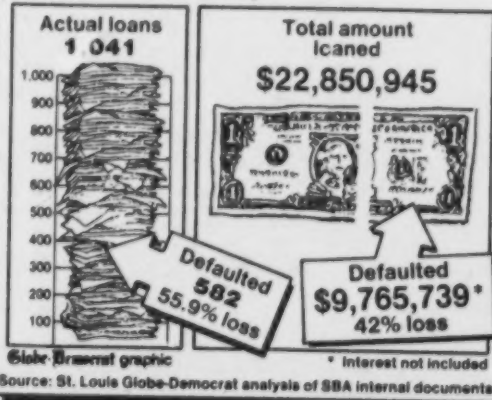
Similar versions of one phrase — "getting the money on the street" — cropped up again and again in Globe-Democrat

interviews with SBA officials in 18 offices nationwide.

The phrase represents what many — including SBA officials — regard as a bureaucratic distortion of the program's original intent of helping individual entrepreneurs become successful businessmen, but has come to be viewed in terms of how many billions of taxpayers' dollars have been doled out.

## SBA loans/defaults

(St. Louis, 1970-78)



## Defaults here among highest

The St. Louis Small Business Administration's office has one of the highest default rates in the country in its direct loans to aspiring businessmen.

From 1970 through 1978, the local office made 1,041 loans, and 582 — or 55.9 percent — ended in default and out of business.

Of the 18 SBA offices selected in The Globe-Democrat's investigation of the agency's direct loan program, only Cleveland had a higher default rate — 56.46 percent of the 859 direct loans made during the same period ended in default.

In St. Louis, the direct loans during the same period totaled \$22,850,945. More than 52 percent of that amount went to the 582 firms that ended in default and out of business. Subsequently, the SBA and taxpayers took a loss on 63 percent of the money loaned to those firms. A total of \$9,765,739 was charged off as a loss by the SBA here, and another \$561,711 in interest owed on the loans was also written off as a loss.

The Globe-Democrat investigation chose

the years 1970 through 1978 because of the high volume of loans and dollars in the program during that period. Most of the SBA loans are for a 10-year period.

For the period chosen, business failure rates were high for the first few years and then declined in the more current years. The default rate here reached 60 percent in 1971; more recently it has been as low as 36 percent. The rate declines in more recent years not because SBA policies or procedures have improved, but because the businesses have not been in the program long enough to determine their ultimate success or failure.

The failure rate in St. Louis by year is: 1970, 56 percent; 1971, 60 percent; 1972, 60 percent; 1973, 65 percent; 1974, 46 percent; 1975, 51 percent; 1976, 38 percent; 1977, 41 percent; and 1978, 36 percent.

Analysis of the SBA loan data for the 18 SBA offices was accomplished by using the specialized computer systems and consultation services of Comshare Inc., an international computer services firm.

# Tales of ruined businesses — and lives

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

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(Part 1 of 2)

"I can't tell you how it would have helped my life so much if they had never given me the damn money. All it did was ruin my life."

The price of failure was high for Elizabeth Taylor, who started a midtown St. Louis restaurant with a Small Business Administration loan and then watched it close.

An SBA-commissioned consultant had advised against the loan, citing a poor location, insufficient capital and her lack of business experience in concluding that the venture would be "perilous."



A TOP OFFICIAL at the SBA office here agreed, saying the \$86,900 loan was "not adequate."

But less than three weeks later, the SBA granted Mrs. Taylor a loan for \$36,700 — less than half the original request. A bailout loan of \$32,000 followed the next year in 1975, but the money was not enough — Mrs. Taylor closed her business last year.

She now lives on a small medical disability payment and food stamps.

Mrs. Taylor is one example of the failures of the SBA's direct loan program, in which tax money — an estimated \$771 million was lost to defaulted loans from 1970-78 — is not the only cost, and taxpayers are not the only victims.

People who applied for loans came to the SBA office here with ideas that represented their lives' ambitions — a chance to run their own businesses, to be independent, to stand on their own feet and to be their own bosses.

BUT IN MANY cases, often when SBA officials did not even follow their own rules and regulations, people who were successful in obtaining the loans not only lost their businesses, but their life savings, their homes and their credit ratings. In one case, a man even lost his family.

When Willie Smith walked into the St. Louis SBA office to apply for a loan to run a small grocery store, he was justly proud of himself. He was, he said proudly, one of the first blacks to be hired as a meatcutter by a St. Louis grocery chain, and he had worked steadily at the trade for 12 years, adequately

supporting his wife and four children. Now he was ready to go to work for himself, running a meat and grocery store.

But at the SBA, no one seemed to know anything about setting up a grocery, and the \$28,900 loan he received proved totally inadequate, he said.

"BY THE TIME we bought stock and paid regular monthly bills, there was nothing left to operate on. We (Smith and a partner) had chosen a bad location, but we didn't know any better. We did about \$3,500 in sales each week, but a feasibility study done a year after we opened said we'd have to pull in \$15,000 a week in sales to survive. We never got over \$5,000," he said.

Smith's operation, the Specialty Meat Co. at 4281 Maffitt Ave., soon raced downhill. A move to a second location, 1424 Dielman Road, Overland, proved no more successful because of the lack of adequate working capital, he said.

"We were always in debt, never able to restock properly and always living hand to mouth," he said. "There was never money to make any payment to the SBA."

"It's the blind leading the blind," Smith said bitterly. "If they (SBA officials) don't know any more than I do, they're not much help. It's nice they gave me the loan, but it's no help if they can't help me succeed."

Smith's business went further and further into the red, despite Smith's working more and more hours. Debts and frustrations began to take their toll in pressure on the family, he said.

"MY WIFE couldn't take the pressure of the debts, and we ended up separating. The whole thing created a lot of hardship for the family. It really tore us up," he added.

Smith's business, started in late 1974, folded in mid-1978. Smith now does "odd jobs" and cuts meat when extra help is needed. He said he takes most of his pay in groceries and then takes them to his estranged wife and children.

"I tried to get a loan to do better in my life, but I got a loan and ended up a lot worse. I guess I've learned a lot," he said.

The price also was high for Mrs. Taylor, a St. Louisian who for years before receiving an direct loan had run a small but successful catering business out of her North Side home.

"When I applied for that first loan in 1974, my world was going pretty good. I had about \$35,000 of my own money, a home with a mortgage that I had paid down from \$21,000 to \$9,000, a car and good health," she said.

"But afterward, after getting the loan and all that followed, I had lost my money, my home, my business and my health. The emotional strain of fighting through this horrible thing has just torn my family apart emotionally. My oldest son got so upset over the business failure that he had a

breakdown," she said.

"I can't tell you how it would have helped my life so much if they had never given me the damn money. All it did was ruin my life," she said.

IN FACT, THE SBA turned down Mrs. Taylor's original request for an \$86,900 loan, in part based on the findings of a feasibility study commissioned by the SBA to look into Mrs. Taylor's idea of a restaurant and catering service at 3536 Washington Ave.

That study, obtained by The Globe-Democrat, stated, "This total concept appears unrealistic for this area of St. Louis at the present time due to the fact that it is a transitional area and the fact that Mrs. Elizabeth Taylor has little management and business experience for such a large operation."

The report called Mrs. Taylor's proposed venture "perilous" and "high risk" because of the location and her lack of business experience.

And, in declining her request for \$86,900, S.C. Slaughter, then chief of SBA's financing division, wrote that the loan could not be approved because, "Working capital of \$23,900 after the loan is not adequate to sustain the operation during its development stages."

So what did the SBA do for Mrs. Taylor? Less than three weeks after Slaughter's letter, Mrs. Taylor received a loan for \$36,700 for essentially the same operation she envisioned in the \$86,900 loan. The \$36,700 loan left Mrs. Taylor with only \$3,700 for working capital, according to SBA records.

A SECOND loan the next year for \$32,000 ended up being used largely to bail Mrs. Taylor out of debts rapidly incurred from the small capitalization in the first loan, records show. The loans were put in liquidation status within two years after they were made, and the business sputtered along for five years before closing in August 1980.

In fact, even though the loans went into liquidation on May 25, 1978, the SBA made no attempt to collect on its loss. The loans were officially charged off on Feb. 23, 1978, records show, again with SBA making no attempt to collect anything. For more than two years after being "charged off" SBA continued to ignore the debt.

By the time the agency finally moved to collect anything on its loan, the business had little left of value, and SBA collected absolutely nothing from the sale of business chattels, giving the sum to the actioners instead.

In the case of Lionel E. Lefler, an American Indian who wanted to open a health club, it was a similar story.

LEFLER HAD been and still is a high school physical education teacher. He



Globe-Democrat Photo by John Dangler

Willie Smith, one of the first blacks to be hired as a meatcutter by a St. Louis grocery chain, works at a confectionery at 3701 Cook. "I

tried to get a loan to do better in my life, but I got a loan and ended up a lot worse. I guess I've learned a lot," he said.

thought he would have no trouble running a health club in the Oakville Shopping Center in South St. Louis County.

Once he got his \$21,000 loan, he had no problems with the SBA and very little contact with the agency, either, he added.

But problems began even before the club opened, Lefler said, when the landlord of the shopping center placed the club in the rear of the complex, not in the front as Lefler had been led to believe.

"It was a poor location, but I didn't realize how bad it was at the time. Maybe if the SBA had given me some management training, I might not have let this happen," he said.

But, Lefler said, he was offered no such courses or help despite the SBA mandates that all borrowers without management

experience, such as Lefler, receive management assistance training.

In fact, Lefler said, he wanted to wait until he could get a better location because his application for the loan had been predicated in part on a choice site for the club. But because the loan had already been approved, he said, an SBA official told him not to wait but to take the money and work with the less desirable location.

**LEFLER'S HEALTH** club opened in early 1978 and lasted a little less than three years. During that time, he received only one visit from SBA officials — "and they were in an obvious hurry to leave," he said.

Although Lefler twice requested and received a moratorium on his loan

payments, no SBA official contacted him about his business problems.

He said he once called the Service Corps of Retired Executives, a group of retired businessmen that offers management help to SBA borrowers, but was told no one there knew the physical fitness business and "then they told me to call back in a few months if things didn't get better."

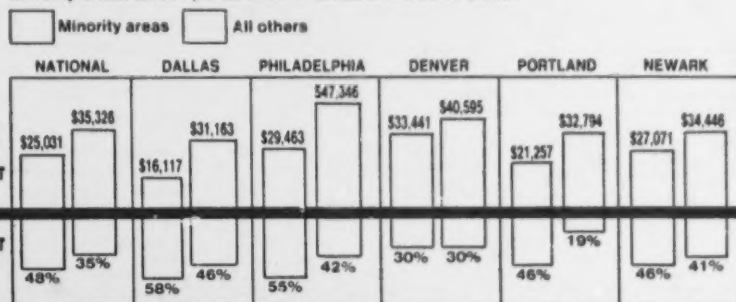
When the business folded in 1980, the SBA had put in a total of \$63,000 and Lefler had lost \$20,000 of his own money, including a house he had owned.

When he thinks back on the venture, Lefler is not bitter and he does not put all the blame on the SBA. Nonetheless, he would change the past if he could.

"I'd have been a lot better off financially if they'd have told me no — hell no."

## SBA loans/defaults (minority areas vs. all others)

A look at underfinancing and default rates in predominantly urban minority areas as compared to other areas in the same cities:



Source: St. Louis Globe-Democrat analysis of SBA internal documents

St. Louis Globe-Democrat graphic

# Deck stacked against minority areas

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(Fifth of a series)

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The Small Business Administration has given smaller loans to borrowers in depressed minority areas than to aspiring businessmen in surrounding regions, stacking the deck against the survival of enterprises in the minority areas, a nationwide Globe-Democrat investigation shows.



Businesses in predominantly non-minority areas are given loans averaging 41.1 percent more than businesses in depressed, minority areas under the Small Business Administration's direct loan program.

And yet minority businessmen argue their needs are at least as great as their white counterparts' because of higher insurance costs, higher security costs and renovation and leasehold improvement costs.

**THE PATTERN OF granting smaller**

loans makes economic survival more difficult for the type of businesses that the SBA's multi-million-dollar direct loan program is designed to foster, the investigation shows.

The smaller loans to minority businesses correspond closely with the higher default rate in minority areas. The Globe-Democrat's investigation revealed that 48 percent of all direct loans in minority areas fail, compared with only 35 percent of the direct loans in predominantly white areas.

The underfinancing in minority areas was disclosed by a computer analysis of 14,261 loans representing 26.8 percent of the more than 51,000 direct loans granted nationwide from 1970 through 1978. Estimates of nationwide performance were based on that sample, representing all defaults in 16 cities in that period.

IN ANALYZING the data, The Globe-Democrat used the specialized computer systems and consultation services of Comshare Inc., an international computer services firm.

In analyzing disparities between minority and non-minority areas, loans were grouped by ZIP code. ZIP codes representing predominantly minority areas were identified through interviews with law enforcement, newspaper and SBA employees in 16 cities.

The average loan amount nationally in predominantly black or Hispanic areas was \$25,031 — but the average in all other areas was \$35,324. The difference of \$10,293 represents a 41.1 percent disparity.

The Globe-Democrat examined the direct loans made from 1970 through 1978 in 16 district offices throughout the country: St. Louis; Phoenix, Ariz.; Detroit; San Francisco; Portland, Ore.; Atlanta; Miami; Minneapolis; Dallas; Cleveland; Philadelphia; Buffalo, N.Y.; Denver; Newark, N.J.; New Orleans; and Washington. The disparity in some district offices, which generally cover either all or a major portion of a state, was particularly acute.

IN DALLAS, for instance, the average SBA loan made in predominantly black and Hispanic areas was \$16,117, but the average loan in all other areas of Dallas was \$31,163 — or 93 percent more.

In Philadelphia, the average loan in black areas of the city was \$29,463, but the average loan in all other areas was \$47,346 — or 61 percent more. The situation was the same in the 16 offices. In each case, areas of high minority concentration received less than predominantly white areas.

Not only has the SBA given smaller loans to minority businesses, it has compounded the problem by concentrating high-risk types of businesses in the depressed areas. In fact, the agency's direct lending portfolio has been heavily concentrated in six types of businesses: bars, restaurants, food stores, cleaning shops, clothing stores, and truck hauling firms.

THOSE SIX TYPES of businesses accounted for 41.6 percent of the 14,261 loans reviewed by The Globe-Democrat, with more than 350 other types of businesses



accounting for the remaining 39.5 percent of SBA direct loans.

Leading the list in terms of numbers of SBA direct loans were restaurants, which received 1,385, or almost one in every 10 loans. Next were bars, which received 1,121 loans, and food stores, with 1,071 loans.

In St. Louis, for instance, although the SBA office made loans to 231 different types of businesses during the period 1970 through 1978, 48 percent of all defaults during that period occurred in those six types of businesses, records show.

The SBA office here and other offices around the nation are seemingly oblivious to the high risk and low need for these types of businesses, but nonetheless continue to finance new bars, restaurants, grocery stores, cleaning shops, clothing stores, and truck hauling firms — and each year more of these same businesses end in failure.

SBA loans for new businesses have been concentrated in a small portion of North St. Louis, Wellston and Kinloch.

This concentration has led to a higher SBA loss ratio (defaults as a percentage of disbursements), pumping hundreds of new businesses into areas where it is difficult to support them economically. The result is a higher loss rate for the SBA and financial hardships for those people receiving the loans in the depressed areas.

**OF 382 LOANS** that ended in default during the period 1970 to 1979, slightly more than 50 percent — 283 loans — were from a two-square mile area in the northern metropolitan area of St. Louis representing only eight ZIP codes. The St. Louis SBA district office makes loans throughout Eastern Missouri.

In comparison, the rest of the St. Louis metropolitan area — representing 44 ZIP codes — accounted for only 38 percent of loan defaults.

The computer analysis by Comshare Inc. confirms what dozens of loan recipients from the northern St. Louis metropolitan area told Globe-Democrat reporters during interviews: Loans within the predominantly black areas were significantly smaller in comparison with loans made in surrounding, predominantly white areas.

The average loan amount in the

## Businesses receiving most SBA loans

| National            |              | St. Louis           |            |
|---------------------|--------------|---------------------|------------|
| 1. Restaurants      | 1,385        | 1. Food stores      | 120        |
| 2. Bars             | 1,121        | 2. Restaurants      | 112        |
| 3. Food stores      | 1,071        | 3. Bars             | 104        |
| 4. Apparel          | 896          | 4. Truck Hauling    | 120        |
| 5. Laundry/Cleaning | 661          | 5. Laundry/Cleaning | 73         |
| <b>TOTAL</b>        | <b>5,134</b> | <b>TOTAL</b>        | <b>529</b> |

predominantly black areas selected was \$17,571, while the average loan in the rest of the St. Louis metropolitan area was \$23,496 — or more than 31 percent greater. Computer analysis by Comshare shows no statistically significant difference in the types of businesses in both areas.

That means that while the same types of businesses received loans in both areas, those in predominantly black areas received less capital for their companies than fellow entrepreneurs in surrounding areas.

**FOR EXAMPLE**, of 67 defaulted loans to restaurants in the St. Louis area, 38 were in the northern portion of the city, and 29 in the entire rest of the metropolitan area. While the average loan amount to restaurants in minority areas was \$16,989, restaurants in the rest of the metropolitan area received an average loan of \$27,991 — or 63 percent more — and suffered a smaller default rate.

The same pattern is true with food stores, where the average loan made to the 41 stores that defaulted in the northern portion of the metropolitan area was \$21,400, while the average loan made to the 15 defaulted stores in the rest of the metropolitan area was \$27,496 — or 28 percent more.

"From a socioeconomic viewpoint," says the agency's procedures manual, "the indiscriminate approval of loans at a high

volume and low rate of success can do nothing but impair our relationship with the small business concerns and communities that we are attempting to help."

The manual also stresses that "many loans are in liquidation solely because working capital requirements were not given adequate consideration."

**SBA OFFICIALS** throughout the nation acknowledge the concentration of loans into the few types of businesses, but argue that because of the agency's policy of accepting loans in chronological order they have little or no control over which businesses get loans.

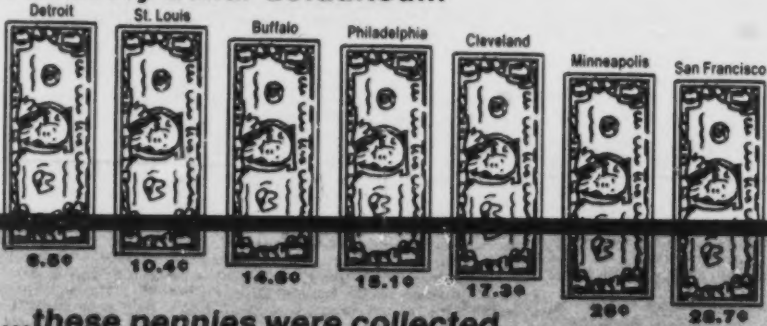
Additionally, they say, the six categories cited are "entry" type businesses that are common for people starting a business. Many SBA officials add, however, that they would prefer a system that would enable them to select loans for businesses based on the needs of the community and on the quality of the applicant, not just on a first-come, first-served basis, as required by their procedures manual.

More than \$74 million was loaned into minority areas while nearly \$400 million went into all other areas, according to documents from the 16 SBA offices. More than 2,900 loans were made in minority areas, and more than 11,000 went into other areas.

## SBA collection efforts (1970-1978)

A sampling based on 534 cases from 16 SBA offices

### For every dollar defaulted...



...these pennies were collected

Globe-Democrat graphics

Source: St. Louis Globe-Democrat analysis of SBA internal documents.

# SBA gets pennies from dollars it's owed

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(Sixth of a series)

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The Small Business Administration collects just pennies on every dollar it is owed in direct loans from businesses that close down, despite regulations requiring "maximum recovery."



Collateral — land, buildings or anything else pledged by a borrower to secure the loan — is often grossly overstated, and, in some instances, is actually non-existent, records show. Collection efforts proceed slowly, and large sums are routinely written off without filing suit against the debtor.

Nationally, a survey of 534 files from 16 SBA offices throughout the nation shows that SBA collects just 18 cents on every

dollar it is owed at the time a loan is placed in liquidation status. In some offices, the rate of collection is even lower. The SBA offices selected serve not only their metropolitan areas but all or major portions of their states.

**IN DETROIT, FOR** instance, records show that the agency collects just 6½ cents on each dollar it is owed at the time a loan is put into liquidation. In St. Louis, 10.4 cents per dollar owed is collected; in Buffalo, N.Y., the figure is 14.6 cents per dollar owed; and in Philadelphia, 15.1 cents per dollar owed is collected.

Two major causes for the poor collection have surfaced in discussions between reporters and SBA field personnel in the 16 offices: the widespread practice of deferring loan payments for borrowers who fall behind in their payments; and the easy willingness of the agency to allow other and later creditors to take a higher priority in their right to collect in the event of a default.

The practice of deferring loan payments, called "gaming" by some SBA officials, often is done to make an SBA office's loan portfolio appear to be more "current" (that is, to have fewer loans in a delinquent status). The deferred loans often are to businesses that are clearly failing, according to field personnel interviewed.

**BY ALLOWING A** recipient to defer payments to the SBA, there is often simply a reduction in cashable assets over the period of deferment rather than a saving of the business enterprise — with SBA ending up with little or nothing left in a business to collect on.

The second major cause of poor collections is the willingness to subordinate the agency's lien position on real property, those interviewed said. This puts the SBA in a poorer legal position to collect than other, later, creditors.

The result, once a business fails, often leaves the agency with no meaningful collection rights. But the new lender, charging high interest rates, makes thousands of dollars for five or six months of participation as a result of its better collection position.

**IN SOME CASES,** the reasons for lack of collection are unclear. What is clear, however, is the small return to SBA.

Some examples:

● On July 31, 1972, the SBA approved a \$350,000 loan to the Martin Luther King Jr. Plaza Corp. in Cleveland. That loan, for a shopping center, was secured by a first mortgage on the land and buildings owned by the borrower, assignment of rights, title and interest in a lease agreement, and

guaranties of lease payments of \$10,000 a year for 10 years to SBA.

On April 26, 1973, another \$21,600 was loaned to the Plaza Corp. Less than a month later, another \$83,000 was loaned to the corporation. Four days later, another \$45,630 was loaned, and one week later, another \$106,000 was loaned to the Martin Luther King Jr. Plaza Corp.

That, however, did not end the federal largesse to the corporation. On Sept. 24, 1973, the agency loaned it another \$52,817, and followed it up in May 1975 with a seventh and final loan of \$93,630. In all, the Martin Luther King Jr. Plaza Corp. received \$765,277 from the SBA.

Slowly, but surely, however, each loan went into default, and the borrowers repaid the SBA a total of only \$4,848 of the \$765,277 loaned. The agency was left holding the bag for another \$100,244 in interest, which was written off with the principal for a total of \$866,673.

What has the SBA collected on its business property collateral, its lease agreements and its guaranties from Plaza?

❖ The SBA made no attempt to collect, but still holds the mortgage paper, which officials now describe as virtually worthless.

● On April 5, 1973, the Dallas office of the SBA approved a loan of \$100,000 to the Meridian Industrial Foundation Inc., as a partial financing of a \$280,000 motel and restaurant project.

To secure its investment of \$100,000, however, the SBA accepted a second lien on the land and buildings of the 24-unit motel and restaurant, a second security interest on the machinery, equipment and furniture, and rights to a portion of equity in a lease purchase agreement.

But when the loan ended up in liquidation, the first lien holder collected. SBA collected nothing.

● On Dec. 3, 1976, the Newark, N.J., office of the SBA loaned \$76,000 to the Strickland Corp. to operate an automotive repair shop.

The loan was secured with a first security interest in the machinery, equipment, fixtures, furniture and inventory, as well as a first mortgage on the business real estate.

Yet when the business closed down four years later, SBA liquidation officers collected a grand total of only \$187.50 and were forced to charge off \$77,642 in principal and minimal liquidation charges.

● On Nov. 15, 1972, the Miami SBA office approved a loan of \$31,000 to the Bryant Trucking Co., with the collateral to include a first lien on unimproved lots in Palatka, Fla., and a first lien on two new Chevrolet dump trucks. The dump trucks were bought for more than \$31,000, according to SBA records.

But just 21 months later, when the loan went into liquidation, the SBA allowed the borrower to sell one of the trucks, and the agency sold the second one at a public sale. The total netted by the agency for the 21-month-old dump trucks was just \$2,524, records show. The SBA did not try to collect anything from the land.

Literally hundreds of cases reviewed contained similar failures to collect on collateral or failure to require a lien position better than second or third position on collateral, which in most cases prove worthless to the agency in recovery attempts.

**THE HIGHEST** collection rate of any of the 18 offices surveyed was in San Francisco, but even there only 28.7 cents was collected on each dollar owed at the time of liquidation.

The Globe-Democrat's examination did find a regional disparity in collection rates, with the Western offices collecting more per dollar than offices in the rest of the nation.

Western SBA officials say this is a result

of using deed of trust foreclosure proceedings on real property. The procedure allows a lender to bypass the necessity of going to court and allows it to obtain a summary foreclosure using a deed of trust. The result is faster and easier collection on real property, which is usually the bulk of collateral.

In the East, on the other hand, collections are complicated by a general lack of deed of trust laws to allow the same summary foreclosures used in the West. And there is a lower per capita rate of home ownership in the East than in the West, some SBA personnel say. With more apartment dwellers, the average loan is secured by less real property.

**IN THE CENTRAL** state offices, there is a mixture of collection rates brought about, apparently, SBA personnel say, by differences in work ethic.

"I really think there is a regional ethic," Denver District Director Chester B. Leedom says. "It has to do with the type of people, and geography has to do with high recovery rates in liquidation. It starts to break down when you get into the large urban areas. The rural states are far better," he says.

Statistically, at least, Leedom's comments are borne out in The Globe-Democrat survey. The Minneapolis district office's collection rate is 26 cents on the dollar, while other, generally urban, states in the central area average far less. Detroit collects 6.5 cents on the dollar; Cleveland collects 17.3 cents per dollar; and St. Louis collects 10.4 cents per dollar. The more rural Western states also have a higher collection rate, as does the rural South, while the industrial East and Central offices lag behind.

But SBA field officials say the basic cause of collection failures gets back to the failure to adequately secure the loan in the first place, and the lack of enough staff members to monitor the loans.

# SBA figures mislead Congress on rate of defaults

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

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(Continued from p. 16)

The U.S. Congress was given reports containing misleading and out-of-date loss rates on direct loans by the Small Business Administration throughout the 1970s, a Globe-Democrat investigation showed.

While the agency was losing one dollar of every three it loaned to businessmen in the direct loan program from 1970 through 1978 — totaling an estimated \$371 million — it never admitted in reports to Congress a loss rate greater than 10.8 percent.



THOSE MISLEADING and understated SBA figures on default rates were accepted without question by the General Accounting Office, Congress' investigative arm, and passed on as fact.

As a result, elected officials have never been given a true and up-to-date picture of loss rates for the quickly deteriorating program, and there has been little concern over loans that have failed far more often than believed. Indeed, misinformed about the magnitude of the losses, Congress has repeatedly increased financing for the program.

SBA reports to Congress from 1970 through 1978 consistently understated loss rates by presenting financial data in such a way as to minimize losses from the \$2 billion put into the program during the 1970s, a Globe-Democrat investigation showed.

SBA officials were able to paint an optimistic picture of the direct loan program losses every year by using cumulative default figures for the life of the program, extending back to the Eisenhower era. This obscured high losses for the last decade by merging the loss rate for any given year into the average loss rates for the early years.

**SBA REPORTING** practices made it virtually impossible to assess the performance of the SBA during any given year.

When the rates are averaged together, the low dollar loss rates for the earlier years serve to hide the serious deterioration of the

program during the 1970s. As a result, the SBA has been telling Congress that the program's dollar default rate was 10.8 percent when, in fact, it was more than three times that high — 33.3 percent — as revealed by The Globe-Democrat's investigation.

In terms of numbers of loans defaulted, the default rate was even higher — 42 percent.

Not only has SBA's loss rate reporting technique kept Congress in the dark, it has kept SBA from knowing what has been happening.

When reporters asked SBA officials about the loss rate during the 1970s, they were told that the agency did not know what it was and that the agency was unable to check what had happened to loans made in any given year.

Reporting only cumulative figures blurs the impact of sharply higher default rates and thereby creates little accountability for the effect of specific policies.

CHARLES R. Hertzberg, director of SBA's Office of Business Loans, acknowledged "at point to The Globe-Democrat, saying, "Admittedly, your method (The Globe-Democrat method of tabulating loss rates by year) would give us a better reflective picture of the effect of our various loan policies."

SBA also failed, and still fails, to report the default rate in terms of numbers of loans — a more significant figure in a program that is designed to help individuals.

The newspaper obtained SBA loan data and files on 14,261 cases throughout the nation under the Freedom of Information Act. The data was analyzed by using the specialized computer systems and consultation services of Comshare Inc., an international computer services firm.

Congress expects to be informed of the progress and problems of the Small Business Administration by the General Accounting Office. But when reporters turned to GAO reports for statistics on loan loss rates, the figures they found turned out to be those passed on from the SBA without confirmation or checking by the GAO.

For instance, a GAO report on Aug. 21, 1979, into the 7(a) direct loan program (one of four business loan categories that make up the direct loan program) carried figures for loss rates for 1975 through 1978 after noting that "SBA's loss-rate figures, for all district offices, for fiscal years 1975-1978 follow..."

**WHAT CAME NEXT** was a listing of

years and loss rates, with 1975 listed as having a loss rate of 6.42 percent; 1976, 6.51 percent; 1977, 6.50 percent; and 1978, 6.61 percent.

What the GAO report failed to mention was that the loss rates were not, in fact, loss rates for each year, but were cumulative totals for all years up to the year cited, and that the figures were not the result of its own study, but were supplied by SBA.

Henry Eschwege, director of GAO's Community and Economic Development Division, which supervises GAO reports, acknowledged to The Globe-Democrat, "We do often have to rely on data from the agencies, but when we find discrepancies, we'll use our own figures."

Although Eschwege said GAO routinely runs "reliability studies" on figures given it by various agencies before including the figures in its reports, an assistant, John Landicho, said that no such studies were undertaken on the SBA default figures, which passed directly from the SBA into GAO reports without questions.

When Globe-Democrat reporters asked GAO Acting Comptroller Milton J. Sokolar about the validity of the figures, he said, "In the final analysis, nobody can absolutely guarantee the accuracy of any figures, but I'd give a lot of weight to GAO figures."

**COULD FIGURES** in GAO's reports for 1970 through 1978 be off the mark? Sokolar replied with questions of his own: "Is it conceivable? Yes. Is it likely? No."

One top SBA official in a Western state, who asked not to be identified, called SBA's reporting system "simply invalid. What possible good does it do to have some cumulative default rate? What matters is to know what's happened to the loans made in a given year."

"Then we'd have some reasonable idea of the effect of our loaning policies for those years. The way it is now, the only purpose really being served is to conceal what's happening from Congress," he said.

Another top SBA official in a Midwestern state, who also asked not to be identified, said the figures were "not representative of the true picture" but added that there were "obvious reasons" for the SBA's method of reporting the loss rate.

"We've been told to push these great programs, but for every person (who gets a loan) at the end of the pipeline, there are 9,999 who don't like government giveaways." Hence, the figures "are masked for the best possible picture," he said.



Globe-Democrat Photo by John Bloomquist

Two businessmen who have been successfully helped by the SBA. At left, Herschell Clark, who owns Clark



Globe-Democrat Photo by Paul Ockressa

Tire Co., at 10520 Big Bend Blvd. At right is Tyree W. Hale in his funeral home at 1238 N. Kingshighway Blvd.

## Success stories tell how SBA should work

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(Eighth of a series)

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Successes in the Small Business Administration's direct loan program have come when SBA granted loans to applicants who had experience in the business and general management, and who invested something of value of their own in the enterprise.

Those success stories point clearly to why 42 percent of the loans end in failure and default.

The agency's lax procedures in the last decade have allowed many without experience or managerial ability and with little personal financial stake in the business to avail themselves of huge amounts of federal money at the taxpayers' expense.

THE GLOBE-DEMOCRAT asked SBA district offices throughout the country to submit a list of borrowers who had gotten direct loans and done well in business, either paying the loan off entirely or continuing to make regular payments.

After interviewing these "successes," reporters found that, in all but a handful of cases, the reasons for success boiled down



to: experience in the business, some general managerial experience, and investment of personal money or equity by the borrower.

The successful firms reviewed by The Globe-Democrat tend to be those that received loans "by the book," that is, with SBA closely following its regulations calling for loans only to those with experience in the business they are seeking to enter, with managerial experience, with "a reasonable amount (of personal equity) at stake in the business" and with an assurance of repayment ability.

The investigation shows those with little business or general managerial experience tend to be the ones who end up in default.

Some examples of the successful businesses:

● In 1971, Seymour Beneroff was running a small, "hole in the wall," corrugated package company in Brooklyn, N.Y., when the city forced him out of his building to

make room for a building project. Beneroff turned to the SBA for a loan to allow him to buy his own building in Linden, N.J., and the agency complied, making him a loan for \$202,500.

Since then, business has boomed and Beneroff has about 75 employees, he says. "Without the SBA's help, I don't think we would have gotten anywhere," he says.

Beneroff had several things going for him, as well. He had spent 18 years in the corrugated package business, spending much of that time as a sales manager and general manager, before founding his own firm, Squire Corrugated Container Corp., in 1967.

Beneroff has his own ideas about what works at SBA and what does not. "When they try to make it a social program, seeking out special groups to help, it seems to fail. But when they stick to helping young businesses, that's when it really works."

● Nunzio J. Incresmona was operating a small garden and florist shop in a Philadelphia mart in 1979 and had been doing a brisk business for several years when an SBA loan official happened to take note of the business and asked Incresmona whether he would be interested in expanding.

With a \$30,000 loan from SBA and \$12,000

of his own money, Incremona set up Incremona's West End Florist and Garden Center in Lansdale, Pa., a Philadelphia suburb. Business has increased 150 percent in the last year alone, and he has expanded into a full-scale nursery and greenhouse, he says.

● St. Louisan Herschell Clark says his SBA direct loan six years ago "really helped me out." At that time, his fledgling firm was undercapitalized and badly in need of money to help it expand, he says. When banks turned him down, he turned to the SBA, which gave him \$20,000.

Clark had about eight years experience in tire operations, including managerial experience, before receiving his SBA loan and opening the Clark Tire Co.

Since then, business has "just about doubled every year," and sales this year will exceed \$2 million, he says. Whereas he had been renting the building where the firm is located, at 10530 Big Bend Blvd., he has since bought the entire block, opened a second store and is considering a third.

In making the loan, SBA did something it now rarely does — it went out and looked at the business location and did thorough cash flow projections. Clark put up two houses

and two cars as collateral.

In addition, SBA did something else it rarely does now — a servicing officer visited Clark every three months or so to check on the business and offer advice. Clark's loan will be paid off in about a year, he says.

● Having been a branch manager for the Wurlitzer Co. in Boston for five years, Gene B. Hale Jr. earned a master's degree in business and then ventured into business. Turned down by banks, he won the approval of the SBA for a \$66,500 loan in 1977 and set up Hale Piano & Organ Co. in a regional mall store in Madison, N.J.

Since then, the SBA has given him another \$88,500 for a second store, and business has been so successful he has been able to open a total of four stores. Sales have more than quadrupled in less than four years, and he has a good relationship with a local bank, enabling him to move out from under the federal government's wing, he says.

● Tyree W. Hale has a long history of experience in the mortuary business in St. Louis, having graduated from mortuary school in 1947 and worked in the business ever since. He built Hale Funeral Home in 1962 at 1238 N. Kingshighway Blvd., and got

his first SBA loan, for \$1,600, in 1964.

Since then, SBA has given him three more loans, totaling \$36,000, enabling him to expand his business, and has sent SCORE (Service Corps of Retired Executives) representatives to help him with specific business problems.

He credits SBA with giving him the chance to expand his business, but adds, "SBA isn't in business to put people in a successful business. They're there to help you, but you've got to be able to make it go yourself."

He advises younger people wanting to get a start in business "to get some working knowledge of the business they want to go into" before they seek a loan.

"I spent a year and a half working in insurance just to find out what kind of insurance problems I'd run into in the funeral business," he says.

In virtually every case examined by reporters, successes in the direct loan program involved people entering a business in which they had had past experience, with at least a modest background of management in some type of business, and with a certain amount of their own equity involved.

## SBA's mission clouded by confusion

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

(Last of a series)

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At the core of the problem with the Small Business Administration's direct loan program is a lack of definition about what really is the program's — and, indeed, the agency's — true mission.

This is the public and private assessment of top SBA administrators in Washington and field personnel in 16 district offices contacted by The Globe-Democrat. Most agreed that there has been confusion over whether the program was to be administered as a social or an economic program. Indeed, the agency's manuals refer to the program as both.

So varied is the implementation and administration of the program that while some district directors swear by it, others swear at it.

"UNLESS LOAN officers were deaf, dumb and blind, the thing that guided them in the last decade was numbers,

not quality," said Earl Chambers, SBA's director of portfolio management. Now, the task is to reorient loan officers into thinking about quality loans, not the quantity of loans, he said.

But to do that, said Charles R.



Hertzberg, director of SBA's Office of Business Loans, "there has to be a stated policy, either from Congress or from the administrator (SBA Administrator Michael Cardenas)."

And "once the policy is clearly stated, then there has to be a period of retraining," Hertzberg said. "If someone grows up in this system and only knows what's gone on for the last 10 years, then there's some serious retraining necessary."

SBA officers quickly pass the blame for a massive default rate in the

program to Congress, complaining that Congress ordered them in legislation to use the loan program to aid various social groups — and in effect make the direct loan program a social program rather than a financial lending program.

"WE'RE THE TOOLS of Congress," said New Orleans District Director Joseph M. Conrad Jr. "Congress should decide what is an acceptable loss rate (in the program)."

What is clear, as The Globe-Democrat has revealed in its long investigation of the SBA, is that the SBA has indeed turned the direct loan program into a social welfare program, but in doing so has mismanaged and distorted it, with the result that:

● More than two of every five direct loans made end in default and failure — and this loss rate is itself understated by the agency's willingness to grant "deferments," largely to make an individual office's loan portfolio "look better."

● More than \$571 million was lost in the program from 1970 through 1978, largely through lax procedures and



loose policies, and that figure can be expected to reach \$900 million if defaults from 1979 and 1980 are consistent with previous years.

**BUT, HERTZBERG** said, "If we reimposed prudent lending policies in regards to direct loans, such as matching dollars for private investment, we would make fewer loans to disadvantaged people. Whether that is right or wrong to do is up to Congress."

- Totally inexperienced and unqualified people often end up receiving loans from the agency, with many soon joining the ranks of failure.

- The very people the program is designed to help often become its victims, as inexperienced recipients who end in failure often lose their life savings, credit ratings, jobs, and in at least some cases, their families as a result of debt and frustration.

Contributing heavily to the high default rate, the inconsistency in the experience of the loan recipients, and the seeming inability of the agency to screen out exceptionally high risk loans, is an agency procedures manual that is loose and ill-defined — leading to a program that has the same characteristics.

**FOR INSTANCE**, while the manual (called Standard Operating Procedure manual) calls for direct loans to have "reasonable assurance of repayment," it never defines exactly what that assurance is. Similarly, the manual requires recipients to have demonstrated managerial ability, but does not define it in any way.

When an applicant has no management ability or experience, he is encouraged to attend a one-day workshop to learn to be a businessman.

The SOPs are equally unclear in terms of guiding a loan officer in how to distribute money within a loan — that is, how to allocate money among equipment, leasehold improvements, working capital or other needs. While the manual indicates that money should not be used to "bail out" a private creditor of the applicant, the language is lax enough to provide virtually any interpretation by a loan officer.

**AND THAT**, the Globe-Democrat investigation found, is exactly what has happened.

- An analysis of a sample of SBA loans showed that a third of the direct loans made by SBA went in part or in whole to pay a borrower's pre-existing business debt. Many of these loans were large loans granted for the sole purpose of paying off past debt.

Other major points in The Globe-Democrat's investigation included:

- The SBA has consistently understated its loss rate to Congress, never admitting in any given year a loss rate more than 10.8 percent — although The

Globe-Democrat determined the actual dollar loss rate was 33.3 percent and discovered that Congress's watchdog, the Government Accounting Office, has simply passed along SBA's figures with virtually no scrutiny.

- Loans made to businesses in predominantly non-minority areas are 41.1 percent larger than loans made in depressed, minority areas.

- The agency's portfolio has been largely concentrated in only six types of businesses — bars, restaurants, food stores, clothing stores, laundry and dry cleaning shops, and truck hauling firms — recognized by commercial lending experts as exceptionally high-risk ventures.

- A severe shortage of servicing personnel makes it wholly unrealistic for the agency to give adequate attention to loans, increasing the chances of failure and diminishing the agency's chances of recovering collateral.

- The agency collects just 18 cents on each dollar it is owed once a loan goes into liquidation, the last step before a loan is charged off as a loss.

**THERE IS ALSO** wide disagreement over how much help the direct loan program actually gives a new businessman by loaning him money directly — that is, without bank involvement — and at a rate well below commercial lending rates.

Washington, D.C., District Director Freddie Collins said the program is necessary because it gets people into business who cannot get any help from banks. "My personal feeling is that the program is not large enough. The demand for the program is so much greater than the supply of money," he said.

But, San Francisco's chief of portfolio management, Russell Stoddard, said, "The direct loan program never gets that borrower into the mainstream of the business community and dealing with a banker. If we cannot reach the small-business men effectively through the banking system, there is no justification for this program. In my judgment, it's not worth continuing."

Denver District Director Chester Leedom said, "One of the fallacies of the direct loan program is the subsidized interest rate. It doesn't do the borrower any good to get an artificially low rate. He just has to face the real world at some point."

And, said Cleveland District Director S. Charles Kemming, "With the amount of demand and the artificial interest rate, I wouldn't try to put Band-Aids on the program. I would eliminate it; it hasn't done that much good. The good that comes out of it would have eventually been there anyway."

# Sen. Dixon Calls For Hearings on SBA Direct Loans

By THOMAS L. AMBERG  
and MICHAEL R. MONTGOMERY  
Globe-Democrat Staff Writers

Citing disclosures in a series of Globe-Democrat articles, U.S. Sen. Alan J. Dixon has called for congressional hearings into the Small Business Administration's direct loan program.

The Illinois Democrat, a member of the Senate Small Business Committee, said Thursday he would ask the committee chairman, Sen. Lowell P. Weicker, R-Conn., to convene hearings "as soon as possible" to "deal with the findings contained in The Globe-Democrat's series."

He said hearings could begin as early as October.

"If The Globe-Democrat's findings are correct, then we've got a program that is in very serious trouble, indeed," Dixon said. "Hearings will enable us to get the answers and perhaps to chart a new path for this program."

Dixon said that while The Globe-Democrat investigation revealed "what seems to be a very high default rate, more importantly, the newspaper has raised the larger questions of what has this program accomplished and where is it going."

**CALLING THE NEWSPAPER'S** series "very constructive," Dixon said he believes Senate hearings will



improve the SBA program. "Our goal is not to hurt, but to help," he said.

"It's also important that we recognize the programs which have been successful, not just those which failed," he added. "But when a program develops problems, it's critical to see that those problems are corrected."

"It's not only essential — it's mandatory — that the Small Business Administration be administered in an impartial and competent way," he said. "The Globe-Democrat has performed a commendable public service by bringing abuses and mismanagement within the direct loan program to light."

After a lengthy and intensive investigation, involving the review of more than 14,261 loans from 16 district offices throughout the nation, The Globe-Democrat disclosed that:

● More than two of every five direct loans end up in default and failure — and the actual loss rate is masked and significantly understated by the

agency's willingness to grant "deferments" to borrowers, largely to make an individual office's loan portfolio "look better."

● More than \$571 million was lost in the program from 1970 through 1978, largely through lax procedures and loose policies, and that figure can be expected to reach \$900 million in defaults if figures for 1979 and 1980 are consistent with previous years.

● Totally inexperienced and unqualified people often end up receiving loans from the agency as loan officers rush to "get the money on the street." Quality has been sacrificed for quantity, top SBA officials say.

● While the program is meant largely to help the disadvantaged and minorities enter the mainstream of the American free enterprise system, the lax practices of the last decade have resulted in many of these disadvantaged people becoming victims of the program, as inexperienced recipients who fail often lose their life savings, credit ratings and jobs as a result of debt and frustration.

● For no apparent reason, the SBA has given an average of 41.1 percent more to businesses in predominantly white areas than to businesses in heavily minority areas — matched by a larger default rate among minority businesses.

Black businessmen interviewed claimed the lower level of financing meant almost "guaranteed failure."

● The SBA collects just 18 cents on each dollar it is owed after a loan has gone into default.

● About one-third of all direct loans made by the SBA went in part or in whole to pay off a borrower's existing business debts — in apparent violation of SBA regulations.

Senator DANFORTH. The findings of their investigation are disturbing. They report that 42 percent of SBA loans in the district offices ended in default. A third of the money loaned out from 1970 to 1978 was never repaid—over \$571 million. According to the *Globe-Democrat*, loose lending practices contributed significantly to the high default rate: Loans were made to businesses sight unseen; loans were made to persons with no training or ability to manage the businesses for which they received the loans; and loans, especially loans in minority areas, were frequently too small to adequately capitalize the business ventures. The Small Business Administration paid little or no attention even to its own procedures in the drive to obligate the money Congress had entrusted it to spend. In the meanwhile, the *Globe-Democrat* found that the SBA consistently understated its loss rate in its reports to Congress.

The cost of the SBA's mismanagement of the loan program is high, but the damage done to the small entrepreneurs who were victimized by the program may be even greater. Persons who participated in the program frequently lost thousands of dollars of their own money, even their life savings—victims of bad advice and counsel from the SBA officials who were purporting to help them. Time and again, people who received SBA loans told the *Globe-Democrat* reporters that they would have been better off if they had never heard of the SBA.

Of course, the program is not without its success stories. In fact, Amberg and Montgomery report that the program did quite well when SBA loan officers followed SBA procedures for making and monitoring loans. Unfortunately, the people at the SBA did not do that often enough.

Mr. Chairman, as a member of the Senate Governmental Affairs Committee, I have learned that it is extremely difficult to legislate good management. However, it is possible and even advisable for Congress to smack the bureaucracy square in the face with a 2 by 4 now and again to remind the people who manage the taxpayers' money that they are under an obligation to do something more than punch a timeclock when they show up for work. Mr. Chairman, the case at hand appears to call for a 2 by 4, and then some.

From my review of the *Globe-Democrat's* report, it would appear that a good deal of the problems associated with the direct loan program can be traced to a fundamental misunderstanding of the program's mission by the people at the SBA charged with the responsibility of administering the program. We are told that SBA officials devoted themselves to the task of getting money "out on the streets," obligating ~~as much money as they possibly could as quickly as possible.~~

But the purpose of the direct loan program, or any assistance program for that matter, is not to throw money on the streets. The purpose of the direct loan program is to provide assistance to small businesses that need help. That means more than simply giving them money. It means taking the time to make intelligent loan decisions, providing counsel where needed, and even turning away prospective loan recipients when it simply does not make sense to make loans. That should not be too much to ask.

Surely administrative reforms are possible which can make the program work. I am confident Mr. Cardenas will commit himself to such reforms this morning. Although other commitments make it impossible for me to remain to hear his testimony, I am extremely interested in his response to the discoveries made by the Globe-Democrat.

At the same time, I hope the committee is prepared to consider legislative action—changes in the law itself—which may encourage administrative reform. It may be worthwhile, for example, to consider reforms in the procedures for distributing loan funds which would reward good performance by SBA district offices and punish bad performance. Allowing for differences in the economic situations of different cities, it may be advisable to make continued funding of the program in any district contingent upon good performance. Offices which betray the public trust by “throwing money on the streets” would soon see their money supply cut off. Given such constraints, my sense is that wayward offices would soon get the message.

From a broader perspective, however, the committee might examine the question of whether it is time to legislate a greater emphasis on counseling small entrepreneurs—using, where possible, the resources available in graduate schools of business—and to move away from direct expenditures and support of small business ventures. It is quite possible that a dollar spent on counseling might do more to help small businesses than would a larger amount of money in direct loan assistance.

Mr. Chairman, you know as well as I that Congress is straining to find ways to cut the Federal budget. Given the SBA's track record in administering the direct loan program, an argument can be made that there could be no better place to start the budget-cutting process. That may be appropriate. Clearly, the best thing the Government can do to help small business is to bring down interest rates. But more may be necessary. It seems to me that at this time, as perhaps at no other time in recent memory, there is a real need for vigorous actions by the Government in support of small businesses. Such actions range from regulatory and tax relief to direct assistance. If the SBA is prepared to get serious about its programs, if the SBA can be made to appreciate the importance of the public trust it holds, then it seems proper to give the SBA a chance to get its house in order. It is clear, however, that tough congressional oversight is necessary to that effort, Mr. Chairman, which is why these hearings are so important. I compliment you on your work thus far, and I stand ready to give you any assistance I can.

Senator WEICKER. Thank you very much, Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator WEICKER. The first witnesses will be Mr. Bernard Lump, Chief Liquidation Officer of the San Francisco district office of the Small Business Administration; and Mr. Taylor Larimore, Chief of the Financing Division of the Miami district office of the Small Business Administration.

Mr. Lump and Mr. Larimore, please come forward.

Senator DIXON. Mr. Chairman, may I make a statement for the record before Mr. Larimore and Mr. Lump testify?

Senator WEICKER. Certainly.

Senator DIXON. I would like to say that during the committee's preparation for these hearings we recognized the importance of reviewing the SBA's field office implementation of congressional policies in agency procedures.

These two SBA employees have detailed knowledge and unquestionable experience in their respective areas that is not otherwise available to the committee. I concluded, Mr. Chairman, that their testimony today was crucial to the oversight and legislative responsibilities conferred upon this committee by the Senate.

Frankly, it was my intention to request that the committee subpoena these two employees. To its credit, Mr. Chairman, the Small Business Administration agreed with the committee's specific request to make these two employees available for today's hearing. I appreciate their cooperation.

Do either of you have any opening statement that you would care to make?

Senator WEICKER. First of all, at this time—and I intend to follow through on this with all the witnesses—I intend to swear the witnesses.

Mr. Lump and Mr. Larimore, would you stand and raise your right hand? Do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. LUMP. I do.

Mr. LARIMORE. I do.

Senator WEICKER. Please be seated.

Any opening statements will be received by the committee at this time.

**STATEMENT OF TAYLOR C. LARIMORE, CHIEF, FINANCING DIVISION, MIAMI DISTRICT OFFICE, SMALL BUSINESS ADMINISTRATION, CORAL GABLES, FLA.**

Mr. LARIMORE. I have an opening statement, Mr. Chairman.

I have been asked to state that the views expressed in this statement are my own and do not necessarily reflect the views and policies of the administration or the Small Business Administration.

Today I consider the most important day in my 27 years of service for my Government, first as a paratrooper in World War II, later as a revenue officer with the Internal Revenue Service, and for the last 18 years as an employee of the Small Business Administration.

Incidentally, my title on the witness list is incorrect. I am Chief of the Financing Division in the Miami district office. This is one of SBA's larger district offices. We are in charge of smaller offices located in Tampa and West Palm Beach. We have the responsibility of assisting the small businesses in the southern half of the Florida Peninsula. I understand that our district has one of the lowest default rates among the SBA district offices.

Last October, the SBA invited field representatives from every region in the Nation to a financial assistance meeting in San Diego, Calif. The purpose of that meeting was to identify the problems that we were having at the field level and to recommend their solution. A primary recommendation of that committee was that



"all direct funds be eliminated from the lending function of the agency."

Our direct loan programs are not needed, they do not work, and they discriminate.

First let us consider why they are not needed. The SBA's direct loan programs were established 28 years ago to provide needed financing for creditworthy small firms which were unable to secure funds from private lending sources.

Banks were reluctant to make long-term loans 28 years ago. Now nearly all of them do. At that time, few banks knew about our guarantee loan program. Now nearly all of them do. Many banks were reluctant to make loans to women and minorities. Now nearly all of them do. At that time, there were a limited number of other lenders. Now there are many.

For example, the yellow pages of the Miami telephone directory has seven pages devoted to loans. Hundreds of private lenders are competing for the opportunity to lend money to creditworthy small businesses or their owners.

During the last fiscal year ending September 30, 1981, the Miami district office received 16,957 nondisaster loan inquiries. Nearly all of these inquiries were referred to banks, which were the source of funds for most of the creditworthy applicants. The majority who could not get a bank loan returned to SBA. Most were entirely unqualified. We were required to review thousands of bank-declined applicants in the hope of approving a few good loans. In fact, of the 16,957 inquiries we received, we approved only 154 direct business loans in all of south Florida.

Today there is no longer a need to justify our inefficient and costly direct loan programs. Our limited resources should not be wasted in this fashion.

Now let us consider why our programs do not work. SBA has acknowledged that 38.8 percent of all of our direct business loans made between 1970 and 1978 are in default, which means that the business is closed and that the loan is in liquidation or charged off.

This totally unacceptable default rate of 38.8 percent does not include loans in deferment; it does not include loans paid in full through liquidation of assets; it does not include loans paid in full by subsequent SBA loans, of which there are many; and it does not include loans where the business has failed but the loan is kept current by payments of the former owner. These unmeasured losses mean that more than 38.8 percent of the businesses we tried to help were actually hurt by our direct loan program. The long-suffering American taxpayer cannot be expected to endure this kind of waste much longer.

Commercial banks average less than 2 percent loss on their business loans. I believe that SBA's direct loan losses are a disgrace. The primary reason our direct loan programs do not work is that every application we consider has already been analyzed and turned down by the businessman's own bank.

A bank must make every sound loan that it can if it is to prosper. How can SBA be expected to make a better credit judgment than the businessman's banker—the banker who knows his customer, knows the neighborhood, and knows the competition, much better than anyone in SBA?



The banker has intimate knowledge of how the businessman handles his finances because he has a readily available bank record. If the bank has evaluated the loan and concluded that the loan does not offer reasonable assurance of repayment, even with SBA's guarantee, is it reasonable to expect SBA to have a different opinion and be correct? This may be why we have more employees collecting loans than we have making loans.

Another reason that the program is not working is that we have a severe shortage of personnel. When I joined SBA, we had three or four loan programs. Now we have between 23 and 45, depending upon how they are counted. We used to have four to five processing loan officers in our Miami office. We now have two. This of course means less time for investigation and analysis.

A third reason our direct programs are not working is our continual efforts to approve more loans. During the past 2 years, each field office was given a target of approved loans it was expected to make. Declined loans did not count. Supervisors and managers were informed that their next year's salary and future promotion depended upon meeting these targets. As a result, a great many weak and marginal loans were made throughout SBA. I believe that our losses during the past 2 years will exceed anything in the history of the agency.

In March of this year, we wisely discontinued the numbers game for approved loans. However, in its place we now have a target to reduce the time spent processing loans. Hopefully the elimination of the direct loan program will allow us to devote needed resources to a quality approach to our other lending programs.

Finally, the direct loan program discriminates. During the past 2 years our direct loans were targeted primarily to minorities and women. Many applicants within these favored groups believe a direct loan is their right. Applicants that are not in these groups become angry when they are told that we have no direct funds for them. As a result, unless we approve an applicant's loan, he frequently becomes frustrated and angry. Sometimes he even writes his Senator.

SBA 2 years ago commenced its new merit appraisal and compensation pay plan. Every finance division chief was given minority and women goals. Salary adjustments were made on the basis of whether a division met or exceeded its goals. In our district, women and minorities received 96 percent of all of our direct loans during fiscal year 1980 and 94 percent of all of our direct loans during fiscal year 1981.

During the past 2 years, we had ample funds for Cuban-born refugee aliens, while at the same time we were telling white, American-born male businessmen—who had been paying taxes—that we have no funds. SBA has been making direct loans primarily on the basis of race and sex. We have become the ultimate discriminator.

Beginning this month, for next fiscal year, our direct funds are targeted to additional special-interest groups. These include energy-type businesses, exporters, handicapped, and veterans. As a result, our loan programs continue to discriminate against the vast majority of small business owners.

In summary, our direct loan programs are not needed; they do not work; and they discriminate; and they should be abolished.

Thank you for your attention. I believe that I have expressed the feelings of the vast majority of SBA field personnel. If you would like, I would be glad to try to answer any questions.

Senator WEICKER. Do you think there is any value in having a Small Business Administration at all, or do you think the matter can best be handled by the banking system?

Mr. LARIMORE. I think the matter can best be handled by the banking system.

Senator WEICKER. Well, certainly your testimony is unique. Maybe it is that it will find favor within the administration—I do not know. Certainly the present economic policies are such that there seems to be little regard for the particular problems that small businesses have.

I would suggest to you, Mr. Larimore, that one of the reasons there is a Small Business Administration is that there are problems out there which are unique to small businesses. A good example would be high interest rates. Big businesses can handle them; small businesses go under.

I suggest to you that if indeed there is some special consideration given various elements of our society in an affirmative sense—what you say is discrimination and what I prefer to say is affirmative recognition of some of the discriminations that have existed in the past which we are trying to eliminate now—it would seem to me that this is the responsibility of the Small Business Administration, as compared to the private sector.

This does not in any manner, shape, or form, go to your knowledge of how this program has been mismanaged. That is why we are here—to receive testimony from that point of view.

As the chairman of this committee, I fully recognize the unique conditions that bring to pass, No. 1, the agency itself; and, No. 2 the particular efforts of that agency.

You are right; the banking community is not going to take a chance on many of the minorities. They are not going to do it. Who is going to do it? Who is going to do it? I am asking you a question.

Mr. LARIMORE. Senator Weicker, frankly I wish you had not asked me the question with respect to, "Can the banking industry handle this problem better than the Government?" My remarks were confined solely to the direct loan program.

Senator WEICKER. But more than that, you feel the whole agency ought to be abolished. That was your response.

Mr. LARIMORE. You asked me a question, and I was forced to give you an honest answer.

Senator WEICKER. You said that the whole agency ought to be abolished.

Mr. LARIMORE. I would like, if I may, to confine my remarks to the direct loan program.

Senator WEICKER. You may confine them, but I think that I first of all have to frame your responses to me in terms of your attitude, and here we start off with an official of the agency saying the agency ought to be abolished. Obviously that then reflects on subsequent testimony.

I will just say one thing: If I did not believe in my employer, I think I would tell him so and get out.

Go ahead.

Mr. LARIMORE. I have great respect for the free-enterprise system. I think it has been unexemplified in what it can produce, as was shown by 200 years of productivity under the free enterprise system. But I feel that the direct loan program, which is a part of SBA, should be abolished, for the reasons which I have stated.

Senator WEICKER. I want to make certain that we are on the same track here. No. 1, you have indicated, for the reasons you have stated this morning, that the direct loan program should be eliminated.

Mr. LARIMORE. Yes, sir.

Senator WEICKER. You have gone far beyond that, though, in response to my question, "Do you feel the agency ought to be eliminated?"—and I get an administration-type speech here on the greatness of the free-enterprise system.

Mr. LARIMORE. I am much less sure that the agency should be abolished.

Senator WEICKER. I think the free enterprise system is great and that private enterprise is fine, but there was a purpose for the creation of the Small Business Administration. There was a purpose for the creation of these programs within the Small Business Administration. Specifically, it was that the private sector was unwilling to do the things which are going to be under discussion here today.

I repeat my question to you: Do you feel there is a role to be played by Government both in terms of the small business community and then within the small business community for those elements of it which might be especially disadvantaged? Is there a Government role or not?

Mr. LARIMORE. Yes, sir, I feel the guaranteed loan program is a viable, successful, working program.

Senator WEICKER. Therefore, what you are telling me is that here is one program which you feel is a good program. Now, who is going to administer this program if we are going to eliminate the Small Business Administration? Or would you like to retract that statement? Do you feel there ought to be a Small Business Administration?

Mr. LARIMORE. It is an extremely complicated question, Senator.

Senator WEICKER. It is not very complicated. You said that the guaranteed loan program, you feel, is a worthwhile program.

Mr. LARIMORE. Yes, sir, I do.

Senator WEICKER. Who is going to administer it?

Mr. LARIMORE. I think the SBA can and does, and they do a good job.

Senator WEICKER. So you feel that there should be a Small Business Administration?

Mr. LARIMORE. I feel that there should be a guaranteed loan program; yes, sir.

Senator WEICKER. Administered by the Small Business Administration; is that correct or not?

Mr. LARIMORE. Yes.

Senator WEICKER. Senator Dixon?

Senator DIXON. Mr. Larimore, you testified that last October the Small Business Administration invited field representatives from every region in the Nation to a financial assistance meeting in San Diego. The purpose of that meeting was to identify the problems that you were having at the field level and to recommend a solution. You testified that a primary recommendation of that meeting was that all direct funds be eliminated from the lending function of the agency. Is that correct?

Mr. LARIMORE. Yes, sir.

Senator DIXON. Where is that recommendation? Was that recommendation one that was adopted in writing and forwarded to the SBA?

Mr. LARIMORE. I received it from our regional office in the form of a memorandum.

Senator DIXON. Do you have a copy of that in your possession now?

Mr. LARIMORE. Yes, sir.

Senator DIXON. Do you have it with you?

Mr. LARIMORE. Yes.

Senator DIXON. May we see it?

Mr. LARIMORE. Certainly.

Senator DIXON. We are going to make a copy of that, if you do not mind, Mr. Larimore.

Mr. LARIMORE. No, sir.

Senator DIXON. That was forwarded to you in the due course of the mails, I take it; or were you at that meeting?

Mr. LARIMORE. I was not at the meeting. To be honest, I would have to look at it again, but I think it was routed to me—I am not sure—I have had it for a long time.

Senator DIXON. I believe we are going to have a witness here sometime this morning, Mr. Larimore, who will testify that he operates a successful business in St. Louis and that without SBA's direct loan program he probably would not be in business today.

Is it your testimony here—at least as I receive it and understand it—that you can think of no cases where the direct loan program has been beneficial and that there are no success stories in this program around the country?

Mr. LARIMORE. No. I think there are many success stories in all of our programs, but I think that the cost-benefit ratio, if you will, is not worth the price.

Senator DIXON. It is not your opinion then that, with the proper safeguards and the proper administrative attention to detail and effective improvement of what is done at the community level, this program can be a success?

Mr. LARIMORE. I do not think so, for the reasons which I gave. We have tried to make the program a success. We have tried very hard for many years. I think it is less successful today than it has ever been.

Senator DIXON. I do not think I have any other questions, Mr. Chairman. I would like to offer for the record the 2 page copy of the memo referred to by Mr. Larimore which purports to be an expression of the view—as I understand his testimony—of the

meeting of field representatives from every region in the country to the effect that the direct loan program should be eliminated.

Senator WEICKER. Without objection, it will be included at this point.

[Material follows:]

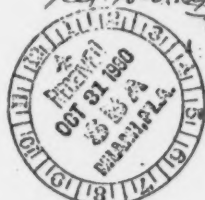




U.S. SMALL BUSINESS ADMINISTRATION  
REGION IV  
1375 PEACHTREE ST., N.E., 5TH FLOOR  
ATLANTA, GEORGIA 30387

*1/10/80  
to Merritt  
Shannon  
McHally*

*Oct 31 1980*



Date: October 29, 1980

Reply to: Merritt E. Scoggins  
Attn of: ARA/FM

Subject: FINANCE MEETING - OCTOBER 6-8, 1980  
SAN DIEGO, CA

To: ALL DISTRICT DIRECTORS  
BRANCH MANAGER

I am circulating the attached papers because you and your staff need to know the problem areas of national agreement coming out of the recent National Financial Assistance Meeting in San Diego, CA. My impression is that District finance people may believe that we in Regional Management do not always convey to Central Office Management, in strong terms, just where the problems are. Suffice it to say that was not the case in San Diego.

You will note that a task force was recommended to begin immediate deliberation with respect to solutions for some of the problems we discussed. For your information, our Fred Stone has been selected to serve on this 5-man force and will be in Washington the week of November 17th.

*Merritt E. Scoggins*  
Merritt E. Scoggins  
Assistant Regional Administrator  
for Field Management

Attachment

*Pearl  
Please route both pages to all LO's &  
other FD personnel.*

*10/30  
11-3-80  
JD*

*Taylor  
11-3*

FIELD RECOMMENDATIONS  
NATIONAL MEETING ON FINANCIAL ASSISTANCE

LOAN PROCESSING

- 1.) The decrease in 7(a) direct loan funds coupled with the increase of targeted groups for such funds would dictate a decrease in the loan limit to allow a more representative lending to the small business person - therefore it is recommended a \$50M administrative limit , (with NO waiver) be placed on direct 7(a) loans. . . .
- 2.) It is recommended the direct loan interest rate be increased to a rate that is equitable or equal to the market rate. This would allow the sale of seasoned direct loans to the banks and also eliminate the subsidized interest rate objection from direct loan program.
- 3.) The small amount of direct funds available coupled with the many problems and pressures involved, such as the Chron list, take a substantial amount of the loan officer's time on an extremely small percentage of his work - therefore, it is recommended all direct funds be eliminated from the lending function of the Agency. If such elimination is not possible, then it is recommended all direct funds for the year be allocated in the first quarter of each fiscal year which will in effect cancel the need for a continuing Chron list and the quarterly funding with its ensuing problems.
- 4.) It is recommended C/Office furnish a national written policy on how direct funds are being used so we will not get the thousands of inquiries from prospective applicants that we cannot help.
- 5.) Field personnel believe the M/A rating system as it now exists is not effective. If such a system is to continue, we feel drastic changes should be made to improve the system.
- 6.) Field personnel feel there should be a consolidation (and simplification) of the many loan programs now existing and new loan programs in the future should be tailored to fit in the consolidated programs.
- 7.) Recommend that an FD task force be formed to review and explore solutions to the above recommendations.

LOAN SERVICING

- 1.) Virtually all of the discussion relative to loan servicing reverted to one area of concern - data retrieval and the computer records.

Senator WEICKER. Now, let us find out how we can directly relate your opinion of the direct loan program to your activities. As I understand it, you are the chief of the financing division of the Miami district office. How many years have you been in that position?

Mr. LARIMORE. Eighteen years—excuse me, I am wrong. I have been with SBA 18 years. I have been chief since December—about 1½ or 2 years.

Senator WEICKER. In the course of the performance of your SBA duties, how much direct contact have you had with the direct loan program?

Mr. LARIMORE. I have very intimate contact and have had for 18 years.

Senator WEICKER. How many loans would you estimate you have personally reviewed during that period of time?

Mr. LARIMORE. Our loan officers handle all of the inquiries. We have averaged about five to seven loan officers. We handle approximately 17,000 inquiries. These directly bear on the direct loan program and our other programs.

When an applicant comes back from a bank—as he is instructed to do—we review his loan request and then give him an application if there is a possibility of a direct loan. We handed out 6,586 applications last year. My share would be one-fifth or one-seventh, as a loan officer, which was most of my career. Now I review all of the loan applications which have been recommended either for approval or decline by our loan officers. I suppose that approximately 40 percent of the direct loan applications that have been processed are declined and 60 percent are approved. That would be my best estimate. We approved 154.

Senator WEICKER. That was 154 direct loans?

Mr. LARIMORE. Yes, sir.

Senator WEICKER. During what period of time?

Mr. LARIMORE. That was last fiscal year in the Miami district, which includes all of south Florida.

Senator WEICKER. How many of those have failed?

Mr. LARIMORE. We have no way of telling what the failure rate on these new loans will eventually be.

Senator WEICKER. None have failed up to this point?

Mr. LARIMORE. I have no records on that.

Senator WEICKER. How about the year before?

I am trying to find out now, after we get through all this rhetoric on whether we ought to have a Small Business Administration direct loan program; exactly what are the facts. I assume that is why you are here.

So far you have estimated that in the last fiscal year 154 direct loans were approved, and you have no knowledge as to how they are going to turn out; right?

Mr. LARIMORE. We hope they all turn out well. But on the basis of what has happened in the past——

Senator WEICKER. Then let us drop back a year. Can you give me the statistics for the year before that?

Mr. LARIMORE. No, I cannot.

Senator WEICKER. All I am saying is: On what factual basis do you make your statements?

Mr. LARIMORE. Eighteen years of working with the program.

Senator WEICKER. All right. I have asked about 2 years, which you cannot give me any response to, as far as factually associating them with the number of loans, number of failures, and so forth. When am I going to get the facts? Do you have something which you can present to this committee which details, from your own personal experience, the inadequacies of the program?

Mr. LARIMORE. I have nothing more than I have in my statement.

Senator WEICKER. Well, if you were in my shoes, would you think that was sufficient to eliminate a legislative program? Or, if you were in my shoes, would you demand something more in the way of fact?

Mr. LARIMORE. If I were in your shoes, Senator, I would certainly consider seriously eliminating the program; that is all I can say.

Senator WEICKER. Would you want more facts if you were in my shoes?

Mr. LARIMORE. I have read—as I imagine you have—the “Globe-Democrat” articles. I thought it was one of the most accurate portrayals of the agency that I have seen.

Senator WEICKER. I am not here to ascertain the correctness or fallacies indeed, if there are any, of those articles; that puts me in the realm of hearsay. But you are here, a member of the Small Business Administration, and you have been directly involved in this program which you have criticized. I have asked you for supporting facts. You are not giving me supporting facts.

Mr. LARIMORE. What specific fact would you like?

Senator WEICKER. I would like you to tell me exactly what your experience with the program has been. You say you cannot tell what is going to happen as far as the last fiscal year is concerned. I have asked you what the track record was for the preceding fiscal year. You do not have that. I am talking about your experience with the program—your experience and nobody else's.

Mr. LARIMORE. It is impossible to determine the loss rate on a set of loans which were made in the last year or two. I cannot give you that information.

Senator WEICKER. Well, I cannot do any more. I repeat: I will not run this committee on the basis of opinion, innuendo, or unsubstantiated claims. I am inclined to think there are problems with this program. I am inclined to think that. But I would be a poor chairman if I were to go ahead and say that is the case in the absence of established fact.

Mr. LARIMORE. There is the established fact that during the years in question—1970 to 1978—38.8 percent of the businesses we tried to help went into default.

Senator WEICKER. All right. Whose fault is that? Is that the Small Business Administration's fault insofar as their administration of the program is concerned? Is that their fault? Or is it that we took the highest risks within our society as a matter of established national policy and therefore to some extent preordained that result? This is what I am trying to find out.

Mr. LARIMORE. I think the fault is perhaps shared by many—the Congress, the administration, the chiefs like myself, the loan offi-

cers, and the hopeful business owners that feel that they are qualified to go into business when they are not.

Senator WEICKER. I have no further questions.

Senator Dixon?

Senator DIXON. If I might pursue that just a bit further, Mr. Chairman—I think that what the Chair and I are concerned about is this: We hear these statistics about the tremendous loss ratio on these direct loans. You suggest it is 38.8 percent. Is that your figure?

Mr. LARIMORE. I understand that is by numbers. I believe the amount in dollars is considerably less.

Senator DIXON. Can you suggest to us why that high percentage—so much higher than the common experience in the financial community generally is concerned—why that tremendously high figure prevails? What is the fault in the program that is causing that? That is the thing we are trying to find the solution to in these hearings—what causes that high failure rate.

Mr. LARIMORE. I think that, at least during the last few years, the targeting of special interest groups to receive direct loan funds seemed to give us the authority for weak loans—at least it was a very permissive atmosphere. Our salaries depended on meeting these targets. The result was that many weak, marginal loans were made that should not have been made.

Senator WEICKER. Did you do that?

Mr. LARIMORE. Yes.

Senator WEICKER. Then is the fault the program, or is the fault yours and others like you? Or is the fault the administration's?

Mr. LARIMORE. Senator, if I talk to 10 of our loan officers, I will get 10 different responses as to what they feel our loss rate should be. We truly do not know whether we should try to meet a banking standard.

As I recall one of the administrators some years ago reading his remarks to Congress, when he was justifying the losses we were having at that time, which I think were in the 40-percent range in the EOL program, his response was, "Well, it's much better to lend this money and lose 40 percent than to give it away in welfare and lose 100 percent."

In the field we really have not been told and do not know the losses that are expected. I might say that, if we did know, it would not be difficult to meet the loss rate that is expected.

Any loan officer can make 99 percent of his loans good by simply discarding all the weak loans and making loans with only 100 percent collateral, and that type of thing. It does not take much of a loan officer, either, to give a loan to everybody who walks in. We have an indefinite target to shoot at, and we try to do what the administration and the Congress would like.

Senator WEICKER. We have no further questions for Mr. Larimore. We will next hear from Mr. Lump.

**STATEMENT OF BERNARD D. LUMP, CHIEF LIQUIDATION OFFICER, SAN FRANCISCO DISTRICT OFFICE, SMALL BUSINESS ADMINISTRATION, SAN FRANCISCO, CALIF.**

Mr. LUMP. I do not have a prepared statement, but I was requested by the committee staff to bring cases that are illustrative of our



lending programs, and I have done that. I also was requested to read a statement from our central office to you. I will read it verbatim. "The views expressed in this statement are my own and do not necessarily reflect the views and policies of the administration or the Small Business Administration."

Senator DIXON [acting chairman]. Where are you stationed, Mr. Lump?

Mr. LUMP. I am presently in the San Francisco district office.

Senator DIXON. How long have you been there?

Mr. LUMP. A bit more than 2 years—since August of 1979.

Senator DIXON. What is your title?

Mr. LUMP. I am the Liquidation Chief.

Senator DIXON. What did you do before that?

Mr. LUMP. Prior to that, I was in the Los Angeles district office from February 1977 until I went to San Francisco. There I was a liquidation loan officer.

Senator DIXON. How long have you been employed by the SBA in this or similar capacities?

Mr. LUMP. Since October 1972. I started in the New York district office.

Senator DIXON. You were in New York first, and then you were in Los Angeles and San Francisco. Is that correct?

Mr. LUMP. That is correct.

Senator DIXON. During the last year or two, what is the caseload that you have handled in the areas where you have served?

Mr. LUMP. I have had two jobs since I have been in San Francisco. I have the one I am presently doing—Liquidation Chief—and prior to that I was the project manager of our experiment. The central office in the last administration sought to better the agency and tried to experiment, and I was the head of that for about 8 months.

Do you want me to speak about the liquidation part of my activities?

Senator DIXON. Please, yes.

Mr. LUMP. The caseload has doubled from almost 300 cases in liquidation to not quite 600—about 570—all loans, direct and guaranteed.

Senator DIXON. You heard Mr. Larimore's testimony, Mr. Lump. What is your opinion of the direct loan program?

Mr. LUMP. I also believe it should be scrapped. I have seen it in all the offices I have been at. Although the ideals are good, the implementation does not work. The way it gets translated is, "Get the money out. It doesn't matter if there is collectability or even if there is a chance of success for the subject businesses." That has been my experience in all offices.

Senator DIXON. When you say that has been your experience—is there actually a policy within the agency along those lines? I have seen that in these articles; I have heard Mr. Larimore refer to it; now you are referring to it. Is that really a fact, or is it just a policy that develops internally in the office among those who are employed there?

Mr. LUMP. Of course you are not going to read it in a manual, but it is the unwritten policy. Supposedly it is going to change. As of when I left the office, it had not. I spoke to a finance loan officer

prior to going, and he said--and I quote—"I approve everything that is on my desk. It is easier."

Senator DIXON. Do you not follow some kind of criterion when you make these loans? Do you not consider whether there is a possibility for success when you talk to an individual who comes in to obtain these loans to see whether you think there is a chance that the individual may actually succeed in what he or she wants to undertake?

Mr. LUMP. It is a hard thing to do. Even if viable existing businesses were the only applicants, it would be difficult. The way the direct lending program is structured, we do not see these kinds of people. We see people who want the American dream. They are working at a job, and they want to go into business. They very rarely have any discernible relevant experience.

We do not try to find the existing businesses that we could help in the direct program. We just react to what walks in our door. Those are the ones with the far-flung dreams. I have very illustrative cases to show you, if you want to see them.

Senator DIXON. Before we get into those specific cases, let me ask you this: Does the agency ever have meetings in the regions involved around the country where everyone gets together and determines certain policies that will be followed in regard to the type of criteria you will employ in making loans?

Mr. LUMP. The criteria are handed down to us by law and by manual. The kind of meetings we have at the district level—I have always been at the district level and prefer that; I like the hands-on experience—the kind of meetings we have there are in regard to what is pending: How many applications are pending; how much is disbursed; you are on target; you are behind target. Those are the kinds of meetings that we have and have had since I have been with SBA.

Senator DIXON. Do they actually suggest to you that there is a target—that  $x$  amount of dollars should be moved out of your agency and your region in a given period of time?

Mr. LUMP. The policy has recently changed from that.

Senator DIXON. How recently?

Mr. LUMP. In the last few months.

Senator DIXON. Under the new head of the SBA, Mr. Cardenas?

Mr. LUMP. Yes.

Senator DIXON. Would you discern an improved policy attitude?

Mr. LUMP. Not yet. I am hoping that there will be, but I think it will be impossible because most of the loan officers and the chiefs are so imbued with this philosophy of getting the money out and writing these loan officers' reports to reflect that there is a possibility of success when everyone knows there is not. I do not know how you could turn that around.

Senator DIXON. Even given the testimony of you and Mr. Larimore that there is  $x$  amount of dollars and that there is a target goal about the amount of dollars you want to move out there, still of course it seems clear to me that there are a good many more applicants than there is money for the applicants.

Mr. Larimore's testimony was that they process 16,000-plus applications and, I think, granted 154 loans.

Mr. LARIMORE. May I correct that?

Senator DIXON. Sure.

Mr. LARIMORE. Those were not applications. Those were original inquiries.

Senator DIXON. OK. But out of 16,000-plus inquiries, is this a fair statement? I have lost my place in your testimony, Mr. Larimore, but I thought you said there were finally 154 loans made.

Mr. LARIMORE. That is correct.

Senator DIXON. Would that be the kind of experience you have in the San Francisco area, Mr. Lump?

Mr. LUMP. I would say it is typical of the three offices I have been in. Each of our offices has a greater volume. They are bigger offices. But it is proportionately similar. Do you understand?

Senator DIXON. Yes. What I do not understand is this: Given the fact that there are so many opportunities for loans and clearly not that many loans made, surely there is a selective process there by which one seeks what would appear to be the best opportunities for success amongst the applicants. Do I make myself clear?

Mr. LUMP. I think what you are saying is that we have a large enough population to get the winners.

Senator DIXON. It would just seem to make sense to me. You must have.

Mr. LUMP. No, we do not. We react to what walks in from the street. We do not go out. Most of our applicants are either unemployed or underemployed and want that cheap money. The banks give them short shrift—most of our inquiries and applicants. You cannot sell soap to people who do not have money. That is the best analogy I can give you.

Senator DIXON. Let me pursue that a moment. In my recollection of the series of articles, as an example, by the "Globe-Democrat," one of the things that I thought stood out there was that so many of the loans were loans made to a fellow who worked in a shoe store, for instance, who now wants to open a restaurant.

Why would you not try to find a fellow who worked in a shoe store who now wants to open a shoe store? Would not his chance for success at least be a little better because at least he worked in a shoe store and knew a little something about a shoe store?

Mr. LUMP. It certainly would, but you probably should not be making shoe store loans either. We tend to make most of our loans concentrated in the very competitive industries—the retailers, the ones that have ease of entry and ease of exit.

Senator DIXON. Such as restaurants, package liquor stores, bars, taverns, and so on.

Mr. LUMP. Retail—you are fighting Macy's. You are fighting the huge discount liquor stores that sell for half of your price. You do not need a great deal of knowledge to get into these areas. These are the kind of applicants we get. We do not go out there to the existing light manufacturers that could expand and use the cheaper money. We do not do that.

Unless we start marketing our product—and money is a product—I think the agency should be abolished. The way we have run for 9 years, I think we have helped primarily our employees and families.

Senator DIXON. Does not the possibility exist though—and I am asking this based upon your experience which you have related

here—that the program would have a degree of viability if it were properly handled?

It seems to me from the testimony of you and Mr. Larimore, both, that there is no criterion involved in this program at all at the national or regional level. There are no directions from above, or at least there have not been in the past, as to how you ought to proceed; and there has been no attempt made to really try to seek the type of loan that has a chance of success.

I am not talking about a person who has 100 percent collateral. Those people do not come to you. I am talking about at least finding the fellow who wants to go into the restaurant business who has been a cock. Does he not have a better chance, or someone of that type?

I would think that some of those things ought to be things that would be obvious.

Mr. LUMP. Yes, they are. Many of our cases are restaurant people who can cook well, but not many restaurants make it; that is the way it is; that is an economic fact. We throw most of our money into those fields.

You said that we did not get any guidance from above—"above" being regional and central offices anyway. The only guidance we have gotten in the past has been, "More production," meaning, "Get the loans out."

Senator DIXON. "Get the money out."

Mr. LUMP. "Get the money out." That is the kind of guidance we have gotten.

Senator DIXON. Is it your testimony here that in all the years that you have been involved in this agency about all they ever tell you is to get the money out? They never tell you how to do it, how to improve what you are doing, or how to become more interested in seeking the kind of goal that will succeed when the money is loaned to someone?

Mr. LUMP. I have seen one attempt at that. That was during the experiment. It was last year, prior to this administration. A group of people from our central office came out with consultants. It was the first time in my career anybody really cared about the small business community from above—from the regional or central offices. It was the only time I have seen it, other than production—"Get the money out, and try to keep the default rate within these parameters." They tell you little secrets on how to do it, but that is it. I do not think there is any great care for the small business community at SBA, or I have not seen it.

Senator DIXON. Let me ask you this based on your experience: Let us suggest for a moment that the program were to be retained. I hear what you are saying—that maybe we ought to get rid of it. But if we are going to have a direct loan program; what could be done within the parameters of that kind of a program to effectively improve the opportunity for good loans, so that these figures of 38.8 percent or 40 percent defaults would no longer obtain and we could really get it down into even single digits? Two percent is considered high in banks, you know. Are there not things that you can suggest to us that could be done to improve the program?

Mr. LUMP. Yes.

Senator DIXON. What?



Mr. LUMP. Mostly they would take legislative changes.  
 Senator DIXON. Give me some examples.

Mr. LUMP. Do not target the money to specific groups. Put the money where the business community needs it. Then you will get job creativity, and you will get the good things. You will get the bang for the buck. If you say you have to make loans to Eskimos, you are not going to get good loans. You are going to get a loan officer who is not analyzing the credit; he is analyzing the social need.

Senator DIXON. But there is a social need in the country, Mr. Lump.

Mr. LUMP. We have not met it.

Senator DIXON. It would seem to me, on the basis of the testimony I have heard from you and Mr. Larimore, that there is not very much effort made to try to seek out the better loan opportunities among those applicants who come to you.

Maybe I am not receiving this in the manner in which you are intending me to receive it, but that is the impression I am getting up here at the table—that you do not really try to find a loan that makes sense.

Mr. LUMP. You are right.

Senator DIXON. But why is that not done?

Mr. LUMP. We have these targets. We have to get money to special groups. We are talking about direct money only now. There is a bit more latitude with the guaranteed program. And we do not market our product. Does that answer your question? If not, I will try harder.

Senator DIXON. No. I think you have answered the question. Thank you very much. Thank you, Mr. Lump.

Thank you, Mr. Larimore.

Mr. LARIMORE. Thank you, Senator.

Senator DIXON. Would Mr. William Saigh and Mr. Luther Boykins step up, please?

Would you both raise your right hands? Do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. SAIGH. I do.

Mr. BOYKINS. I do.

Senator DIXON. Thank you very much. Please take a seat.

Do you have a prepared statement—either one of you?

Mr. SAIGH. I do.

Senator DIXON. Mr. Saigh, would you please proceed then?

#### STATEMENT OF WILLIAM SAIGH. LETTUCE LEAF RESTAURANT, CLAYTON, MO.

Mr. SAIGH. I am a professor turned restaurateur and the owner of the Lettuce Leaf Restaurants.

During my sabbatical in 1976, my wife, Christine, and I created the concept of an entree dinner salad restaurant. There was no restaurant of its kind in the country, and there still is not to this date to my knowledge, so we were doing what no one else was doing or had ever done in the food industry.

Being a professor and raising two young children by myself before my marriage 7 years ago to Christine, my family made gifts



of many of our domestic needs, so we had no particular collateral of concrete value.

I approached the SBA for a loan; and after I had gone through the purgatory of filling out redundant application forms the SBA sent me out to acquire a loan from a bank of my choice, suggesting that they would guarantee 90 percent of the loan.

I felt that to have achieved this level of success was tough. It involved a number of meetings with the SBA and bringing to those meetings persons like Professor Joe Meek, my colleague and financial advisor; and Kathy Boos, who was to be and is now the manager of the Lettuce Leaf; and the officers of the SBA, Bernie Markowitz and "Buzz" Slaughter. They were tough taskmasters. They were not handing me gifts. I visited 17 banks over the next several months and met with no success.

At the 17th bank, a young man in his early twenties informed me that I could get a direct loan from the SBA, a fact of which I was not aware. I contacted the SBA and asked the criteria for a direct loan and was told of the two letters of refusal from the banks. I had my money very shortly thereafter.

However, I had to attend classes at the SBA office directed by the house attorney and others explaining in some general but helpful terms the pitfalls of going into a small business.

Later, I was assigned an advisor—I think a SCORE person, whose name escapes me—who was a retired restaurateur, to give me more specific information about restaurants and who would be available any time I felt I needed him.

Besides all this, after painstakingly building, furnishing, hiring, training, and opening our doors months later, we did have visitations by the SBA personnel, some of whom I recognized.

The Lettuce Leaf was an instant success, so much so that we wanted to open a second one in the downtown area of St. Louis about a year later. I approached the SBA for another direct loan, and they flatly refused. I inquired about a participating loan, and they very reluctantly agreed, but only after a very careful examination of our books and financial situation, et cetera, et cetera.

Another year and a half later, they would not even speak to us for any other kind of loan, direct or otherwise. They pushed us out of the nest, so to speak, and we successfully acquired a direct loan from a bank in St. Louis for our third restaurant, which incidentally is out in Kansas City.

In my opinion, the Small Business Administration must be allowed to continue to function for the benefit of the marginally unfinanceable individuals of this country, for a number of very important reasons.

Inasmuch as the very greatest part of innovation—invention and significant change in this country—comes about by virtue of necessity or of some emergency rather than by some deliberate effort and predetermination, it is indeed these kinds of individuals that we must support and encourage. Many of these kinds of persons emanate from the marginal fringe of unfinanceable persons.

If the SBA is phased out of existence or modified too stringently, these kinds of individuals will have nowhere to turn for funds. Venture capitalists are not really that adventurous. Banks certainly will not pick up the pieces. They are already extraordinarily and

extremely cautious, because their loans are so closely scrutinized by various Federal, regional, and State agencies.

Anything submitted to a bank for a loan must be so absolutely substantiated with proof of success that this perception and thought process rules out any new, innovative, unprovable-before-the-fact ideas. I can attest to that personally.

This country will be denied the kind of initiative that made the free enterprise system work in the first place—that is, when the country was young and when banks and bankers were willing and “allowed” to make large risk-bearing determinations.

One must remember that large corporations are notoriously not innovators. I learned that through my profession. They are dominated by professional managers who do not and will not hire the wild-eyed dreamers who are inclined to foster change. They abhor change more than nature abhors a vacuum. They actually fear change because it may spell their corporate demise. So anyone who does not fit the corporate mold does not work or last long enough to effect innovative changes.

Under the best of circumstances, roughly 35 percent of all manufacturers in the United States end up their fiscal years in the red, and all retail new starts have a mortality rate of approximately 51 percent. For restaurants, incidentally, I think it is closer to 70 percent.

If you add those two up and divide by two, you arrive at a failure rate of 43 percent, which is greater than the failure rate of the SBA that the Globe-Democrat reporters Amberg and Montgomery complain about.

I am not suggesting that a failure rate of over 40 percent is acceptable. And I am convinced that the failure rate can be substantially reduced by modification of criteria to qualify for a direct loan and, incidentally—after I heard this other testimony—other means.

Two letters of refusal from the banks is downright silly. However, I believe strongly that a nominal failure rate can be and should be sustained and tolerated by the taxpayers for all of the good benefits derived from the successful borrowers.

Personally, I—I alone—would gladly tolerate one meaningful success for each meaningless failure in order to support and encourage entrepreneurship, because it is entrepreneurship spawned by the wild-eyed maverick that will ultimately continue to keep this country in a position of leadership in the world in commerce and in politics.

In my opinion, many of the failures of the recipients of the SBA loans were individuals who were well informed and well aware of the risks involved. I find it distasteful of these individuals to ultimately lay the blame heavily upon those who are risking their reputations to give them aid.

Also, whether the directives of other administrations suggested or implied a very lenient attitude toward the administration of funds for minority persons—blacks, women, Hispanics, or Lebanese with Ph. D.'s—would be a question beyond my ability or knowledge to answer.

I am not saying that the small or relatively small business person has an exclusive claim on entrepreneurship or imaginative

audacity, but certainly it is most characteristic of small business. I am not even suggesting that big business never exercises imaginative audacity, but even if it is evident from time to time it is also rare. This is strange, inasmuch as and considering that all big businesses were small at some time and what made them big in the first place they have nearly forgotten and abandoned.

I was born of an entrepreneur, and I have been a spokesman for entrepreneurship all my adult life. I believe I could build a very strong argument that would document the fact that entrepreneurial audacity, innovation, imagination, invention, and risktaking are the single greatest asset that this country of ours has. I strongly suggest that these great capacities of ours are what make the free-enterprise system free and that without the free enterprise system it is doubtful whether we would be free at all.

Thank you for the privilege and honor of appearing before this committee.

Senator DIXON. Thank you, Dr. Saigh. We will get back to you in a moment. Let us hear from Mr. Luther Boykins.

Mr. Boykins?

#### STATEMENT OF LUTHER BOYKINS, ST. LOUIS, MO.

Mr. BOYKINS. First of all, thank you for the invitation up here.

I have operated two very successful barber shops located at 3706 Shreve and 4122 Shreve from 1961 until 1970. In 1970, I started to operate Luther's Market—Luther & Trupe's Market.

I would like for you to just address any questions that you would like to, please.

Senator DIXON. Mr. Boykins, obviously Dr. Saigh has testified here of his experience with the SBA direct loan program in the city of St. Louis, in which he obtained a loan and entered a business which has been, as I interpret his testimony, highly successful. What was your own experience? What type of loan did you apply for?

Mr. BOYKINS. My first meeting with SBA was in 1969. I tried to open Luther & Trupe's Market. At that particular time I had \$25,000 of my own money to operate the market as a general grocer's. It would take \$55,000 to operate the market.

My first experience with SBA was that they would lend me \$10,000 to open up the market. They gave me a \$10,000 loan on my credibility. Within a month's time or a couple of months' time, they would give me the \$25,000. At that particular time \$25,000 was the ceiling.

I am saying that if \$25,000 is the ceiling of a loan, how can you open up a market at \$55,000? This is what the researchers of General Grocers had given to me. I had directly taken that down to SBA.

Unfortunately, at that time they had no administrator. St. Louis has been a problem area for the SBA. In 1969 it was said that the only thing they were basically interested in, since they had a low minority loan policy, was to get the money out. So this is the bind that most people were caught up with in the Small Business Administration, even myself.

Senator DIXON. What had been your background when you went in and asked for that loan to open up a market? What had you done before that?

Mr. BOYKINS. I was a very successful barber. I am still a barber at 3706 Shreve and 4122 Shreve.

I would like to direct this question here; and I am not trying to put anybody on the spot, because I have great admiration for Mr. Larimore here. I had AAA credit at this particular time. I could get no bank participation even though I had collateral at this particular time at the Jefferson Bank—stocks and bonds worth \$15,000.

Senator DIXON. So as a matter of fact you did have some collateral at the time.

Mr. BOYKINS. I had \$25,000 in cash.

Senator DIXON. And you obtained an initial loan for how much?

Mr. BOYKINS. For \$10,000.

Senator DIXON. Then were you given another loan later?

Mr. BOYKINS. Yes, I was. After the \$10,000—as a matter of fact I was given three. SBA has said that they made a mistake with me and with others. I was given a loan for \$10,000, a loan for \$25,000, and a loan for \$65,000. Each time the loan was made, the loan had to be repaid.

Senator DIXON. Has SBA obtained a judgment against you now in connection with that whole loan?

Mr. BOYKINS. Yes, they have.

Senator DIXON. Has any amount been paid back?

Mr. BOYKINS. No, not at the present time.

Senator DIXON. Have you worked out any kind of a repayment plan with the Government?

Mr. BOYKINS. Unfortunately in my case in St. Louis, I am very involved in the community. Some might consider it to be radical or whatever. I have not been able to reach agreement with SBA. This has been 10 years ago.

Senator DIXON. Mr. Boykins, you were quoted, I think, in that article as saying, "I was going to be a failure in the grocery store no matter what. The combination of a lack of experience and a lack of working capital doomed me." Is that your opinion now?

Mr. BOYKINS. Yes, it is. I think that basically you have answered the questions, and the panel has answered the question of why SBA is a failure. I feel that at this particular time with SBA that if they felt that you had no history in the grocery business, why make a loan—if you do not have any experience in it? You just asked why give a person in a restaurant a loan when he is going to open up a shoe store. It does not make sense. This is the problem here.

Not only that, but the people in General Groceries had advised SBA not to make the loan of \$25,000 under the circumstances.

Senator DIXON. Did anybody consult with you at the time that you went in for the loan? Did anyone in SBA discuss with you the fact that you did not have any experience in the grocery store business, that all of your experience was that of a barber, and advise you of the risk that you were entering into?

Mr. BOYKINS. No. Here again, they were basically only concerned about getting money out. They were not concerned about how



successful the program would be. At this time, St. Louis was low as far as loan recipients were concerned. They were basically concerned about just getting the money out.

I feel that they were not concerned whether a person was successful or not. As a matter of fact, we had a group called the Young Entrepreneurs. We personally came to Washington to express this, and we expressed it in the newspaper. I do not think the SBA in the early 1970's was looking for successful business ventures. I think they wanted to point out, "Here are some things; we tried." I think this is the feeling now.

As you can see in our communities now, there are no black businesses whatsoever. At one time you saw all the clothing stores. There was moneylending for clothing stores that people had no expertise in at all as well as the grocery business. It was just a bad experience. There was no leadership there at all as far as SBA was concerned.

Senator DIXON. Mr. Saigh, I take it from your testimony, however, that that was not your experience—what Mr. Boykins has suggested—the lack of counseling and things. I sense from what you have said here that you did receive counseling from them and suggestions about the possibility of success and so forth. I would like to have you elaborate about that.

Mr. BOYKINS. Excuse me. Could I just interrupt 1 second before you ask that?

Senator DIXON. Surely.

Mr. BOYKINS. I would like for you to ask him what year it was when he first came in. You see, I opened up in 1969. Then we can go from there.

Mr. SAIGH. It was 1976. They were particularly tough about their feelings about my eventual success in the restaurant business. I had no restaurant experience. So they were a little dubious. But we had a series of meetings at which we had to talk like Dutch Uncles to convince them.

Senator DIXON. But they did consult with you and counsel you about the risk factor involved and otherwise carefully analyzed with you what you were undertaking?

Mr. SAIGH. Absolutely.

Senator DIXON. You felt that in your case they approached it in a businesslike way?

Mr. SAIGH. Very much.

Senator DIXON. But in your case, Mr. Boykins, you felt that all they were trying to do was give you some money and that they did not consult with you about the risk involved?

Mr. BOYKINS. Here again, I am asking you to look at the data on it. I am saying in 1969; he is saying in 1976. Your records would show in this particular time that this was the downfall of most black businesses and minority businesses with SBA. We asked for different counsel as far as business was concerned. In 1976 I think they might have been a little more up-to-date. I think that when you first start off you have the failures. I think we were used as a scapegoat.

Let me say this: The two gentlemen who were testifying were very truthful in what they were saying. You will find that most people in SBA could not care less. The loan officers or the head



people are in the political arena. In the political arena it is a stepping stone.

Take our office in St. Louis. We have had a changeover there. When I first got there, we had no director. From there, we had a very personal friend of mine, Curtis Crawford. He stayed 6 months, and then he got a promotion as a Federal parole officer in Washington, D.C. After that, they named another black, Merrill Harrington, who did a very sufficient job. On return, he opened up three Kentucky Fried Chicken places.

What I am saying is this: I do not think there was the care that should be there. I think this is a part that we have to realize. You have individuals here testifying. You do not need me to testify, because they are the heads of it, and they have just got through saying that they did not think the program would work. Now, if they did not think the program could work, how could an individual coming and asking for help be successful?

Senator DIXON. Has SBA contacted you anytime since the obtaining of the judgment against you to work out any type of repayment program in respect to what you owe, Mr. Boykins?

Mr. BOYKINS. Yes, I have approached them. As the gentleman said earlier, I wanted to be a part of the American dream. For 9 years you have been successful; you have AAA credit; then all of a sudden the SBA comes along and says, "Hey, we want to help." Then, as things did not go right, I asked them what payments I should give.

Senator DIXON. Have you made any payments since then?

Mr. BOYKINS. I have not. First of all, when you get a loan of \$65,000 and you lose \$25,000, you get a divorce, you lose your home and furniture, it is kind of hard when a person comes and asks you what type of payments you can make because you did not make the payments.

I feel that I owe SBA, without a doubt. I will, if I ever come into any money, pay them. But under the circumstances that I have asked them to work out—they have settled with other people for \$500.

Senator DIXON. Mr. Saigh, your own experience is that you are making your payments now?

Mr. SAIGH. Consistently. I actually hate to do so because the interest rate is so low.

Senator DIXON. Well, I want to thank you both for coming here.

Mr. BOYKINS. Excuse me, Senator. Let me just ask one question with Mr. Saigh here.

I think that one of the things that is true of the Lettuce Leaf here is this: You are talking about a person with a professional background. You are not talking about a person with no knowledge of business. Let me explain this in closing.

You will find that most white individuals will have some type of background in business. If not his cousin, his brother-in-law, or someone is in business. On the other side, from a black point of view, or from a minority point of view, you will not find anybody in the mainstream of life.

I think you just mentioned this. We operate with mom-and-pop organizations. You are talking about the barbershops; you are talking about the little mom-and-pop stores.

In the black community the Lettuce Leaf would be considered a big business, but in the corporate world it is considered a small business. So I do not think you can get a professional person and ask him for the expertise of how to run a business, because the expertise is already there. The gentleman just cited that he was a professor at Washington University, which is one of the highest colleges in St. Louis.

Mr. SAIGH. St. Louis University.

Mr. BOYKINS. St. Louis University.

As I was saying, there is no comparison of backgrounds.

Senator DIXON. Thank you very much, Mr. Boykins. Thank you, Mr. Saigh.

Mr. SAIGH. Could I make a final comment?

Senator DIXON. You certainly may.

Mr. SAIGH. I have given this a great deal of thought, of course. I know exactly what you are saying.

I think we have to get practitioners involved in the SBA organization itself. For example, every business and every trade has an association; I do not care what trade you talk about. Every association is supported by everybody in the trade.

I think they would gratuitously lend a hand to the SBA and the individuals who probably want to go into business, because it is the trade that supports them. If they are successful, the association is successful.

Let me address something to the statement you made. My parents are here from Lebanon. One spoke relatively fluently; the other one did not speak English at all. They ended up in this country owning six grocery stores just by the sweat of their brows and hard work, without any prior knowledge about grocery stores. They used to raise figs. I just want to put that in the record.

Senator DIXON. I want to thank you both. Thank you very much, Mr. Boykins. Thank you, Mr. Saigh.

The next witness is Mr. Lowell Dodge, Associate Director, Community and Economic Development Division, General Accounting Office, Washington, D.C.

Mr. Dodge, you have with you Mr. Dennis Fricke and Mr. James Donaghy. Is that correct?

Mr. DODGE. Yes, sir.

Senator DIXON. Would you raise your right hands, please? Do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. DODGE. I do.

Mr. FRICKE. I do.

Mr. DONAGHY. I do.

Senator DIXON. Please be seated.

Mr. Dodge?

**STATEMENT OF LOWELL DOLGE, ASSOCIATE DIRECTOR, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C., ACCOMPANIED BY DENNIS FRICKE, SENIOR EVALUATOR; AND JAMES DONAGHY, SENIOR EVALUATOR, GAO**

Mr. DODGE. We welcome the invitation, Senator Dixon, to discuss our report on the Small Business Administration's economic opportunity loan program.<sup>1</sup>

Mr. Fricke, to my left, is the head of our SBA audit staff; and Mr. Donaghy, to my right, directed our work on the particular report which we will discuss today.

With your permission, I would like to summarize my statement and request that the full statement be included in the record.

Senator DIXON. Please do.

Mr. DODGE. Our review showed that the economic opportunity loan program has been a means to sustain economic progress for relatively few borrowers. We concluded that program results were unsatisfactory and that attempts need to be made to improve them.

Under the Omnibus Budget Reconciliation Act of 1981, the economic opportunity loan program is no longer distinct from SBA's primary section 7(a) loan program. However, businesses that had been eligible for economic opportunity loans will continue to be eligible for business loans under the new section 7(a)(11). To the extent that lending under that section continues to reflect the deficiencies cited in our report, the conclusions and recommendations of our report will remain applicable.

Through fiscal year 1980, SBA approved over 65,000 economic opportunity loans totaling over \$1.1 billion. Our review of this program included an examination of borrowers who received loans through fiscal year 1978 and who were no longer carried in SBA's portfolio of outstanding loans. Our purpose was to see how many of these borrowers had established ongoing businesses.

The borrowers no longer in the portfolio, we should point out, represent 70 percent of the loans disbursed through fiscal year 1978. More than half of this group were borrowers who had defaulted on their loans and lost their businesses, and slightly less than half were recorded as paid in full.

To look more closely at those recorded as paid in full in the belief that this category might be an indicator of the program's achievement, we took a statistical sample of borrowers recorded as paid in full during fiscal years 1969 through 1978 at four major SBA district offices—New York, Chicago, Los Angeles, and Miami.

Based on our investigation of this sample, we estimated that for these four locations only 36 percent of the borrowers listed as paid in full had established ongoing businesses or, stated alternatively, nearly two-thirds had not.

Bringing into our calculations those who are recorded as having defaulted on their loans, we estimate that only 15 percent of all the borrowers no longer in the portfolio had succeeded in establishing ongoing businesses.

We checked to see how many of the 104 businesses in our sample of paid-in-full borrowers who had ongoing businesses had grown

<sup>1</sup> The report entitled "Most Borrowers of Economic Opportunity Loans Have Not Succeeded in Business," Dec. 8, 1980, has been retained in committee files.

into significant sources of employment. We found that 79 of these borrowers were still in business and willing to give us information. Of these, only two had developed into substantial enterprises employing, between them, a total of 160 people. The others were still mostly very small, and 60 percent still had two or fewer employees.

Moreover, the outlook for many borrowers still in SBA's portfolio is not good. As of August 1981, the proportion of portfolio loans which were delinquent or in liquidation was the highest that it had been at the end of any of the last 9 fiscal years. That rate was 35 percent. This is the percentage that SBA calls its trouble loan rate.

In short, the costs of producing the relatively few lasting businesses have been very high. SBA expects to lose about \$342 million, excluding unpaid interest, on economic opportunity loans disbursed through fiscal year 1980 or about 33 percent of all disbursed amounts.

The costs of failure to unsuccessful borrowers, as has been pointed out earlier, must also be considered. Many gave up good salaries to enter business and invested almost all of their liquid assets. With the failure of their businesses, they were, in many cases, in worse economic condition than before they took on small business ownership.

The program's legislative history does indicate that SBA was expected to take greater risks in the economic opportunity loan program than in its regular business loan program. Greater losses and a higher failure rate than customary in Federal business loan programs could therefore have been expected.

Our review did find that borrowers' inexperience, low capital investment, and disadvantageous locations were significant causes of business failures. However, our review also showed that the following three management and operating deficiencies within SBA contributed to the program's low yield:

First, loan officers at SBA district offices frequently did not assess loan applicants' business projections, management abilities, and the sufficiency of the loan amounts.

Second, SBA's goal system is incomplete, focusing efforts on lending in quantity but not on lending effectively. Goals were established, in other words, for making loans but not for creating successful businesses.

Third, in an effort to allocate limited direct loan money fairly, SBA placed loan applicants who met minimum credit standards on waiting lists and funded them in turn as money became available. As a result, long waiting periods for loans developed at many offices, and less qualified applicants could receive loans at the expense of better qualified applicants they preceded on the waiting list.

In light of these three findings, we recommended to the SBA that they take these three steps at minimum: First, require better assessments of loan applicants' prospects for establishing successful businesses and the loan amounts most likely to help them reach this goal; second, establish program goals which direct efforts toward producing successful, lasting businesses and monitor the progress of the program toward reaching these objectives; and, third, upgrade minimum standards for the program so that only



the best qualified applicants who could be funded within a reasonable time were admitted to the waiting lists.

Because the economic opportunity loan program had social as well as economic goals and serviced businesses which could not qualify for other business lending, some departures from traditional lending practices seemed warranted in the area of repayments. In fact, SBA has tried some special assistance techniques, such as refinancing the troubled loans and granting deferments to borrowers, but without much success.

Three other methods for assisting borrowers—grace periods on initial repayments; graduated repayment schedules under which loan payments would increase as businesses became better established; and early, intensive management assistance—have not been adequately tested because their use has been too limited. So we recommended that the SBA Administrator test the effectiveness of these three techniques for alleviating borrowers' undercapitalization and experience.

Finally, we recommended that the congressional oversight committees monitor SBA's implementation of our recommendations for management improvement and their impact on program results. We said that, if the results did not improve, the committees should determine whether the objectives of the economic opportunity loan programs could be achieved more effectively by committing the funds to other Federal programs with similar objectives.

SBA did not indicate whether it would implement these recommendations. They did say however that one of the most useful changes that they could make would be to inform loan applicants of historical program results as presented in our report, so that the applicants could better assess the wisdom of starting a business or taking on more debt.

We note that SBA has recently discontinued the use of dollar loanmaking goals in the economic opportunity and other loan programs. The SBA headquarters has advised its regional offices that they will not be evaluated henceforth on dollar lending goals. However, SBA has yet to take the next important step, which is to replace that now terminated goal with goals that look to the results of the lending rather than the lending itself, and specifically to measure achievement in terms of the numbers of lasting businesses SBA helps create and sustain.

Senator Dixon, that ends my prepared statement. We would be happy to answer any questions you might have.

Senator DIXON. Thank you very much, Mr. Dodge. I presume you have a complete text you can give to the reporter to be incorporated in the record of this proceeding.

Mr. DODGE. Yes, we do.

Senator DIXON. Without objection, it will be inserted at this point.

[The prepared statement of Mr. Dodge follows:]



UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY  
EXPECTED AT 9:30 A.M.  
TUESDAY, OCTOBER 27, 1981

STATEMENT OF  
LOWELL DODGE  
ASSOCIATE DIRECTOR  
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE  
COMMITTEE ON SMALL BUSINESS  
UNITED STATES SENATE

ON

THE SMALL BUSINESS ADMINISTRATION'S  
ECONOMIC OPPORTUNITY LOAN PROGRAM

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

WE WELCOME YOUR INVITATION TO DISCUSS OUR REPORT ON THE  
SMALL BUSINESS ADMINISTRATION'S (SBA'S) ECONOMIC OPPORTUNITY LOAN  
PROGRAM. OUR REVIEW WAS REQUIRED BY PUBLIC LAW 95-507. THE  
COMPTROLLER GENERAL'S REPORT WAS RELEASED TO THE CONGRESS ON  
DECEMBER 8, 1980, (CED-81-3).

OUR REVIEW SHOWED THAT THE ECONOMIC OPPORTUNITY LOAN PROGRAM  
HAD BEEN A MEANS TO SUSTAINED ECONOMIC PROGRESS FOR RELATIVELY  
FEW BORROWERS. WE CONCLUDED THAT PROGRAM RESULTS WERE UNSATIS-  
FACTORY AND THAT ATTEMPTS NEED TO BE MADE TO IMPROVE THEM. OUR  
REPORT INVITES THE CONGRESS TO MONITOR SBA'S IMPLEMENTATION OF  
OUR SPECIFIC RECOMMENDATIONS, DESCRIBED BELOW. FINALLY, THE RE-  
PORT RECOMMENDS THAT UNLESS PROGRAM RESULTS IMPROVE, CONGRESS  
SHOULD CONSIDER REDIRECTING FUNDS FOR THE ECONOMIC OPPORTUNITY  
LOAN PROGRAM TO OTHER FEDERAL PROGRAMS FOR DISADVANTAGED BUSINESS  
OWNERS.

RECENT LEGISLATION HAS AFFECTED THE ECONOMIC OPPORTUNITY LOAN PROGRAM. THE OMNIBUS BUDGET RECONCILIATION ACT OF 1981 CONSOLIDATED VARIOUS SBA LOAN PROGRAMS, INCLUDING THE ECONOMIC OPPORTUNITY LOAN PROGRAM, INTO A SINGLE BUSINESS LOAN PROGRAM UNDER SECTION 7(a) OF THE SMALL BUSINESS ACT. ALTHOUGH THE ECONOMIC OPPORTUNITY LOAN PROGRAM IS NO LONGER DISTINCT FROM THE PRIMARY SECTION 7(a) LOAN PROGRAM, BUSINESSES THAT HAD BEEN ELIGIBLE FOR ECONOMIC OPPORTUNITY LOANS WILL CONTINUE TO BE ELIGIBLE FOR BUSINESS LOANS UNDER NEW SECTION 7(a)(11). SBA HAS NOT YET ESTABLISHED NEW REGULATIONS AND PROCEDURES TO IMPLEMENT THE STATUTORY CHANGE. TO THE EXTENT THAT SECTION 7(a)(11) LENDING CONTINUES TO REFLECT THE DEFICIENCIES CITED IN OUR REPORT, THE CONCLUSIONS AND RECOMMENDATIONS OF OUR REPORT WILL REMAIN APPLICABLE.

#### ORIGIN AND MISSION OF THE PROGRAM

THE PROGRAM ORIGINATED WITH THE ECONOMIC OPPORTUNITY ACT OF 1964, AS PART OF THE "WAR ON POVERTY." AT THE TIME OF OUR REVIEW IT WAS ONE OF SEVERAL SBA PROGRAMS TO HELP SOCIALLY OR ECONOMICALLY DISADVANTAGED PEOPLE CREATE AND DEVELOP SMALL BUSINESSES. THROUGH FISCAL YEAR 1980, SBA APPROVED OVER 65,000 ECONOMIC OPPORTUNITY LOANS FOR OVER \$1.1 BILLION. THIS TOTAL INCLUDES \$722 MILLION IN DIRECT LOANS AND \$402 MILLION IN LOAN GUARANTEES.

THE PROGRAM WAS ESTABLISHED WITH A DIFFICULT MISSION. IT FUNDED BUSINESSES THAT COULD NOT GET ASSISTANCE FROM OTHER SBA PROGRAMS OR FROM THE PRIVATE SECTOR. TO BE ELIGIBLE FOR A DIRECT LOAN, A BUSINESS MUST HAVE BEEN REJECTED FOR FINANCING

BY TWO BANKS AND BEEN FOUND UNQUALIFIED FOR SBA'S PRINCIPAL BUSINESS LOAN PROGRAM, THE 7(a) PROGRAM. BORROWERS THAT WE SAMPLED WERE USUALLY JUST STARTING OUT IN BUSINESS AND OWNED MOSTLY VERY SMALL RETAIL OR SERVICE BUSINESSES WITH LOW SALES AND FEW OR NO EMPLOYEES.

RELATIVELY FEW BORROWERS  
ESTABLISHED ONGOING BUSINESSES

OUR REVIEW INCLUDED AN EXAMINATION OF BORROWERS WHO RECEIVED LOANS THROUGH FISCAL YEAR 1978 AND WHO WERE NO LONGER CARRIED IN SBA'S PORTFOLIO OF OUTSTANDING LOANS, TO SEE HOW MANY HAD ESTABLISHED ONGOING BUSINESSES. THESE BORROWERS REPRESENT 70% OF THE LOANS DISBURSED THROUGH FISCAL YEAR 1978. MORE THAN HALF OF THIS GROUP WERE BORROWERS WHO HAD DEFAULTED ON THEIR LOANS AND LOST THEIR BUSINESSES. SLIGHTLY LESS THAN HALF ARE RECORDED AS "PAID-IN-FULL."

TO LOOK MORE CLOSELY AT THOSE RECORDED AS PAID-IN-FULL, WE TOOK A STATISTICAL SAMPLE OF BORROWERS RECORDED AS PAID-IN-FULL DURING FISCAL YEARS 1969 THROUGH 1978 AT FOUR MAJOR SBA DISTRICT OFFICES: NEW YORK, CHICAGO, LOS ANGELES, AND MIAMI. BASED ON OUR INVESTIGATION OF THIS SAMPLE, WE ESTIMATED THAT FOR THESE FOUR LOCATIONS ONLY 36% OF THE BORROWERS LISTED AS PAID-IN-FULL HAD ESTABLISHED ONGOING BUSINESSES, OR STATED ALTERNATIVELY, NEARLY TWO-THIRDS HAD NOT. BRINGING INTO OUR CALCULATIONS THOSE WHO HAD DEFAULTED ON THEIR LOANS, WE ESTIMATED THAT ONLY 15% OF ALL OF THE BORROWERS NO LONGER IN THE PORTFOLIO HAD SUCCEEDED IN ESTABLISHING ONGOING BUSINESSES. TRANSLATED INTO NUMBERS OF BORROWERS FOR THESE FOUR OFFICES,

WHICH ACCOUNTED FOR ABOUT 18% OF SBA'S NATIONWIDE TOTAL OF PAID-IN-FULL BORROWERS, WE FOUND THE FOLLOWING:

|                                    |       |
|------------------------------------|-------|
| LOANS NO LONGER IN THE PORTFOLIO   | 6,882 |
| DEFAULTED LOANS                    | 4,103 |
| LOANS RECORDED AS PAID-IN-FULL     | 2,779 |
| ESTIMATE OF PAID-IN-FULL BORROWERS |       |
| WITH ONGOING BUSINESSES            | 1,010 |

WE ALSO CHECKED TO SEE HOW MANY OF THE 104 BUSINESSES IN OUR SAMPLE OF PAID-IN-FULL BORROWERS WHO HAD ONGOING BUSINESSES HAD GROWN INTO SIGNIFICANT SOURCES OF EMPLOYMENT. SEVENTY-NINE OF THESE BORROWERS WHO WERE STILL IN BUSINESS GAVE US INFORMATION. OF THESE, 2 HAD DEVELOPED INTO SUBSTANTIAL ENTERPRISES EMPLOYING A TOTAL OF 160 PEOPLE. THE OTHERS WERE STILL MOSTLY VERY SMALL. SIXTY PERCENT STILL HAD TWO OR FEWER EMPLOYEES.

MOREOVER, THE OUTLOOK FOR MANY BORROWERS STILL IN SBA'S PORTFOLIO IS NOT GOOD. AS OF AUGUST 1981, THE PROPORTION OF PORTFOLIO LOANS WHICH WERE DELINQUENT OR IN LIQUIDATION (35.8 PERCENT) WAS HIGHER THAN IT HAD BEEN AT THE END OF ANY OF THE LAST 9 FISCAL YEARS.

THE COSTS OF PRODUCING THE RELATIVELY FEW LASTING BUSINESSES HAVE BEEN HIGH. SBA EXPECTS TO LOSE ABOUT \$342 MILLION (EXCLUDING UNPAID INTEREST) ON ECONOMIC OPPORTUNITY LOANS DISBURSED THROUGH FISCAL YEAR 1980, ABOUT 33% OF ALL DISBURSED AMOUNTS. THE EXPENSES OF ADMINISTERING THE PROGRAM SHOULD BE ADDED TO THESE COSTS BUT ARE UNKNOWN BECAUSE SBA DOES NOT ACCOUNT FOR THEM SEPARATELY.

THE COSTS OF FAILURE TO UNSUCCESSFUL BORROWERS ALSO MUST BE CONSIDERED. MANY GAVE UP GOOD SALARIES TO ENTER BUSINESS AND INVESTED ALMOST ALL THEIR LIQUID ASSETS. WITH THE FAILURE OF THEIR BUSINESSES, THEY WERE IN WORSE ECONOMIC CONDITION THAN BEFORE THEY TOOK ON SMALL BUSINESS OWNERSHIP.

WHY PROGRAM COSTS AND THE RATE  
OF BORROWER FAILURE WERE HIGH

THE PROGRAM PRODUCED RELATIVELY FEW LASTING BUSINESSES FOR A VARIETY OF REASONS, SOME INHERENT IN THE PROGRAM'S NATURE, OTHERS RELATED TO THE WAY IT WAS MANAGED AND OPERATED. THE PROGRAM'S LEGISLATIVE HISTORY INDICATES THAT SBA WAS EXPECTED TO TAKE GREATER RISKS IN THE ECONOMIC OPPORTUNITY LOAN PROGRAM THAN IN ITS REGULAR BUSINESS LOAN PROGRAM. GREATER LOSSES AND A HIGHER FAILURE RATE THAN CUSTOMARY IN FEDERAL BUSINESS LOAN PROGRAMS COULD THEREFORE HAVE BEEN EXPECTED.

OUR REVIEW FOUND THAT BORROWERS' INEXPERIENCE, LOW CAPITAL INVESTMENT, AND DISADVANTAGEOUS LOCATIONS WERE SIGNIFICANT CAUSES OF BUSINESS FAILURES. HOWEVER, OUR REVIEW SHOWED THAT THE FOLLOWING THREE MANAGEMENT AND OPERATING DEFICIENCIES WITHIN SBA CONTRIBUTED TO THE PROGRAM'S LOW YIELD.

- LOAN OFFICERS AT SBA DISTRICT OFFICES FREQUENTLY DID NOT ASSESS LOAN APPLICANTS' BUSINESS PROJECTIONS, MANAGEMENT ABILITIES, AND THE SUFFICIENCY OF LOAN AMOUNTS.
- SBA'S GOALS SYSTEM WAS INCOMPLETE, FOCUSING EFFORTS ON LENDING IN QUANTITY BUT NOT ON LENDING EFFECTIVELY. GOALS WERE ESTABLISHED FOR MAKING LOANS BUT NOT FOR CREATING SUCCESSFUL BUSINESSES.



--IN AN EFFORT TO ALLOCATE LIMITED DIRECT-LOAN MONEY FAIRLY, SBA PLACED LOAN APPLICANTS WHO MET MINIMUM CREDIT STANDARDS ON WAITING LISTS AND FUNDED THEM IN TURN, AS MONEY BECAME AVAILABLE. AS A RESULT, LONG WAITING PERIODS FOR LOANS DEVELOPED AT MANY OFFICES, AND LESS QUALIFIED APPLICANTS COULD RECEIVE LOANS AT THE EXPENSE OF BETTER QUALIFIED APPLICANTS THEY PRECEDED ON THE WAITING LIST.

TO REDUCE LOAN LOSSES AND INCREASE THE NUMBER OF SUCCESSFUL BUSINESSES PRODUCED BY THE PROGRAM, WE RECOMMENDED THAT THE SBA ADMINISTRATOR

- REQUIRE BETTER ASSESSMENTS OF LOAN APPLICANTS' PROSPECTS FOR ESTABLISHING SUCCESSFUL BUSINESSES AND THE LOAN AMOUNTS MOST LIKELY TO HELP THEM REACH THIS GOAL;
- ESTABLISH PROGRAM GOALS WHICH DIRECT EFFORT TOWARD PRODUCING SUCCESSFUL, LASTING BUSINESSES AND MONITOR THE PROGRESS OF THE PROGRAM TOWARD REACHING THESE OBJECTIVES; AND
- UPGRADE MINIMUM STANDARDS FOR THE PROGRAM SO THAT ONLY THE BEST QUALIFIED APPLICANTS WHO COULD BE FUNDED WITHIN A REASONABLE TIME WERE ADMITTED TO THE WAITING LISTS.

REMEDIAL MEASURES COULD HAVE  
HELPED BORROWERS AND IMPROVED  
THE PROGRAM'S PRODUCTIVITY

BECAUSE THE ECONOMIC OPPORTUNITY LOAN PROGRAM HAD SOCIAL AS WELL AS ECONOMIC GOALS, AND SERVICED BUSINESSES WHICH COULD NOT QUALIFY FOR OTHER BUSINESS LENDING, SOME DEPARTURES FROM TRADITIONAL LENDING PRACTICES SEEMED WARRANTED.

SBA HAS TRIED SOME SPECIAL ASSISTANCE TECHNIQUES--REFINANCING OF TROUBLED LOANS AND GRANTING DEFERMENTS TO BORROWERS--BUT WITHOUT MUCH SUCCESS. THREE OTHER METHODS FOR ASSISTING BORROWERS--GRACE PERIODS ON INITIAL REPAYMENTS; GRADUATED REPAYMENT SCHEDULES UNDER WHICH LOAN PAYMENTS WOULD INCREASE AS BUSINESSES BECAME BETTER ESTABLISHED; AND EARLY, INTENSIVE MANAGEMENT ASSISTANCE--HAVE NOT BEEN ADEQUATELY TESTED BECAUSE THEIR USE HAS BEEN TOO LIMITED.

BORROWERS DID NOT USUALLY ACCEPT THE MANAGEMENT ASSISTANCE OFFERED TO THEM. IN ADDITION, THE ASSISTANCE CAME TOO LATE--AFTER THEY HAD ALREADY MADE CRUCIAL DECISIONS ON LOCATING AND OPERATING THEIR BUSINESSES AND ON HOW TO SPEND THE LOANS. THE ASSISTANCE PROVIDED WAS ALSO TOO LIMITED--NOT OF A SCOPE OR DURATION CONSISTENT WITH BORROWER NEEDS. MOST BORROWERS THAT WE INTERVIEWED REPORTED THAT THE MANAGEMENT ASSISTANCE THEY RECEIVED HAD LITTLE EFFECT ON THEIR BUSINESSES.

WE RECOMMENDED THAT THE SBA ADMINISTRATOR TEST THE EFFECTIVENESS OF THE THREE TECHNIQUES MENTIONED ABOVE FOR ALLEVIATING BORROWERS' UNDERCAPITALIZATION AND INEXPERIENCE.

WE ALSO RECOMMENDED THAT THE ADMINISTRATOR CONSIDER APPLYING OUR RECOMMENDATIONS TO MINORITY BUSINESS LENDING IN SBA's 7(a) PROGRAM, WHICH ALSO HAD A HIGH RATE OF BORROWER DEFAULT AND WHICH IS ADMINISTERED BY THE SAME ORGANIZATIONAL UNITS AND UNDER THE SAME PROCEDURES AS THE ECONOMIC OPPORTUNITY LOAN PROGRAM. TWENTY PERCENT OF MINORITY 7(a) LOANS DISBURSED THROUGH FISCAL YEAR 1978 HAD BEEN CHARGED OFF OR WERE IN LIQUIDATION AS OF MAY 1979.

NOW THAT THE ECONOMIC OPPORTUNITY LOAN PROGRAM HAS BEEN CONSOLIDATED WITH OTHER LOAN PROGRAMS UNDER SECTION 7(a), IT WOULD BE APPROPRIATE AND TIMELY FOR SBA TO CONSIDER OUR RECOMMENDATIONS IN DRAFTING ANY REVISIONS TO ITS REGULATIONS OR PROCEDURES UNDER THIS SECTION OF THE ACT.

RECOMMENDATION TO THE SENATE AND  
HOUSE COMMITTEES ON SMALL BUSINESS

FINALLY WE RECOMMENDED THAT THE CONGRESSIONAL OVERSIGHT COMMITTEES MONITOR SBA'S IMPLEMENTATION OF OUR RECOMMENDATIONS FOR MANAGEMENT IMPROVEMENTS AND THEIR IMPACT ON PROGRAM RESULTS. WE SAID THAT IF RESULTS DID NOT IMPROVE, THE COMMITTEES SHOULD DETERMINE WHETHER THE OBJECTIVES OF THE ECONOMIC OPPORTUNITY LOAN PROGRAM COULD BE ACHIEVED MORE EFFICIENTLY BY RECOMMITTING THE PROGRAM'S FUNDS TO OTHER FEDERAL PROGRAMS FOR SOCIALLY OR ECONOMICALLY DISADVANTAGED BUSINESS OWNERS.

SBA COMMENTS ON OUR REPORT

IN ITS WRITTEN COMMENTS ON OUR REPORT, SBA SAID THAT THE PROGRAM "AS A WHOLE" HAD NOT FAILED. SBA SAID THAT THE ECONOMIC OPPORTUNITY LOANS ARE THE HIGHEST RISK PORTFOLIO. THEY TURNED BACK TO US THE QUESTION OF WHAT PERCENTAGE OF SUCCESS SHOULD BE CONSIDERED ACCEPTABLE IN THIS TYPE OF PROGRAM.

SBA DID NOT INDICATE WHETHER IT WOULD IMPLEMENT OUR RECOMMENDATIONS NOR DID IT PRESENT ANY ADDITIONAL FACTS OR VIEWS WHICH WOULD CAUSE US TO MODIFY OUR CONCLUSIONS OR RECOMMENDATIONS. SBA DID SAY, HOWEVER, THAT ONE OF THE MOST USEFUL CHANGES IT COULD MAKE WOULD BE TO INFORM LOAN APPLICANTS OF HISTORICAL PROGRAM RESULTS AS PRESENTED IN OUR REPORT SO THAT THE APPLICANTS COULD

BETTER ASSESS THE WISDOM OF STARTING A BUSINESS OR TAKING ON MORE DEBT. WE AGREED. IN RESPONSE TO SBA'S QUESTION ABOUT WHAT IS AN ACCEPTABLE RATE OF SUCCESS, WE STATED THAT SBA, AS THE AGENCY ENTRUSTED WITH THE MANAGEMENT OF THE PROGRAM, SHOULD DEFINE ACCEPTABLE PERFORMANCE.

WE ALSO NOTE THAT SBA HAS RECENTLY DISCONTINUED THE USE OF DOLLAR LOAN MAKING GOALS IN THE ECONOMIC OPPORTUNITY AND OTHER LOAN PROGRAMS. SBA HEADQUARTERS HAS ADVISED ITS REGIONAL OFFICES THAT THEY WILL NOT BE EVALUATED ON DOLLAR GOALS AND THAT THEIR PROGRAM LEVELS SHOULD BE REALISTIC. IN SO DOING, SBA SHOWED SIGNS OF HEEDING AN ADMONITION GIVEN BY ITS OWN PROCEDURES MANUAL:

"FROM A SOCIOECONOMIC VIEWPOINT, THE INDISCRIMINATE APPROVAL OF LOANS AT A HIGH VOLUME AND LOW RATE OF SUCCESS CAN DO NOTHING BUT IMPAIR OUR RELATIONSHIP WITH THE SMALL BUSINESS CONCERNS AND COMMUNITIES THAT WE ARE ATTEMPTING TO HELP. WHEN A LOAN IS MADE WITH LITTLE OR NO CHANCE OF SUCCESS AND THE BUSINESS SUBSEQUENTLY FAILS, NOT ONLY HAS THE BORROWER BEEN BURDENED WITH A SUBSTANTIAL DEBT WHICH CANNOT BE REPAYED BUT THE ENTIRE COMMUNITY HAS BEEN GIVEN CAUSE TO QUESTION OUR JUDGMENT AND CREATE A LACK OF CONFIDENCE IN US TO THE DETRIMENT OF OUR PROGRAMS IN THAT COMMUNITY, AS WELL AS IN OTHERS THROUGHOUT THE COUNTRY."

WE THINK THIS IS A WELL EXPRESSED STATEMENT OF WHY THE LENDING PRACTICES FOLLOWED IN THE ECONOMIC OPPORTUNITY LOAN

PROGRAM SHOULD NOT CONTINUE UNCHANGED. WE CONTINUE TO BELIEVE THAT OUR RECOMMENDATIONS SHOULD PLAY AN IMPORTANT ROLE IN GUIDING THESE NEEDED CHANGES.

- - - -

MR. CHAIRMAN, THIS CONCLUDES MY PREPARED STATEMENT. WE WILL BE GLAD TO RESPOND TO ANY QUESTIONS.

Senator DIXON. When was that report filed, or when did you send your findings and your directions for future improvement of the Agency to the SBA?

Mr. DODGE. SBA was supplied with the copy of the final report in December 1980 and had an opportunity prior to that to comment on the draft report. So they have had it, in other words, for well over a year at this point.

Senator DIXON. Is there any communication between your agency and the SBA now, or has there been in recent months, concerning this program?

Mr. DODGE. There has been some. Of course they are required by law to respond to the Congress within 60 days after the report is published indicating what they plan to do in response to the recommendations.

We have also held informal meetings with Mr. Cardenas, and our SBA audit staff is in constant contact with SBA staff.

While there is movement to consider the kinds of recommendations we have made, we have yet to see the specifics of it.

Senator DIXON. Let me start with a general question. You have heard all the comments here this morning. You have been in the audience, have you not?

Mr. DODGE. Yes.

Senator DIXON. Did you have an opportunity at any time to read the series by the St. Louis Globe-Democrat which pointed out some of the problems with the program in their research around the country?

Mr. DODGE. Yes; we have read that series.

Senator DIXON. That has been made available to you?

Mr. DODGE. Yes.

Senator DIXON. In a general sense, do you believe that the direct loan program can succeed if the proper criteria are followed? I notice the three recommendations you have made. We will go into that in a moment. But given the proper kind of internal guidelines and safeguards, in your opinion, is there a possibility for a successful direct loan program in the country?

Mr. DODGE. We think that the program needs to be given a chance through the application of internal improvements before we are prepared to conclude that it should be terminated.

Senator DIXON. I am pleased to hear you say that. It appears to me on the basis of everything I have read, including the Globe-Democrat articles and the testimony that I have heard here today, that the program has been very loosely administered in the past.



One would almost observe that there were no internal guidelines at all based on what I can ascertain.

But it seems to me that to take that kind of an experience and say that because of that the program has failed is to come to a conclusion without giving an opportunity for success to be evaluated in the program. Would that be your observation of it, Mr. Dodge?

Mr. DODGE. We would agree. I think that only now, with the announcement of a new policy—abandoning the old goal to get dollars out on the street—we see the beginning of the kind of changes that might lead the program down a more successful path.

Senator DIXON. Do you believe that that particular policy has now been abandoned by the agency? There is no longer the policy at the level of the various offices of simply getting the money out on the street without regard to what occurs?

Mr. DODGE. That much is true. We have seen the memorandum that announces that policy to the regions. However, with regard to the specific recommendations that we make as to what should happen when the loan officer sits down with the applicant and what should be done to the goal structure of the program, we have not seen significant movement.

Senator DIXON. Just to get the past experience into the proper context, a variety of figures has been used as the failure rate. What was the figure you just employed that your agency felt was the failure rate for the historical past of this agency's direct loan program?

Mr. DODGE. We have looked at the economic opportunity loan segment of the direct loan program, and that is the program in which you would expect the highest failure rate because of the pronounced goal of assuming the highest risk.

We chose basically to look at a slightly different measure than the one traditionally used. We look at the number of ongoing businesses that are created, on the understanding that that is really what the intent of the legislation is. You can read language to that effect in section 2(c) of the statute.

We think, in other words, that it is less helpful to look at various characteristics of the lending itself and much more important to look at the results of the lending and for SBA to structure its performance targets in those terms.

With respect to the specific failure rate that we found in the economic opportunity loan program, I would like to turn to Mr. Donaghy.

Senator DIXON. This is those that have actually succeeded and have endured for a period of years and presumably are making their payments?

Mr. DODGE. The ones that we would look to calculate a success rate would be that population; yes.

Senator DIXON. Those are the ones we are talking about now, the ones that you would call a success based on the fact that they have been in business some time now, they are making their payments; right?

Mr. DODGE. The success rate we found depends on what you take as your base—it is 15 percent of all the borrowers who have left the portfolio, through default or through whatever means. It is 36

percent of those reported as paid in full, which we take to be quite a low rate, an unacceptably low rate.

Senator DIXON. You are saying that in the whole country, in the whole program, and in the history of the program, only 15 percent are current in payments?

Mr. DONAGHY. No, Senator. That is not exactly what we found. We started out with the repayment rates on loans. These are based on the number of loans disbursed from the beginning of the program to 1978. If you regard all those loans disbursed as 100 percent, 39 percent of those loans were charged off or in liquidation as of May 1979.

Senator DIXON. They are complete failures?

Mr. DONAGHY. Yes.

Senator DIXON. So 39 percent have gone under?

Mr. DONAGHY. That is right. That represents borrowers who defaulted on their loans and lost their businesses.

Then you have 31 percent of the loans paid in full.

Senator DIXON. You would call those complete successes, I suppose?

Mr. DONAGHY. Well, they are partial successes. They left the program as apparent successes. They succeeded in business to the extent they were able to pay off their loans.

Then the remaining percentage of loans—30 percent—is still in the portfolio, still active.

Senator DIXON. I do get 100 percent then. You are saying 39 percent have completely gone under; they are goners.

Mr. DONAGHY. That is right.

Senator DIXON. And 31 percent are out of the system—somehow current when they got out of the system. Whether they endured and are still afloat is a matter no longer within your purview.

Mr. DODGE. That is precisely what we spent most of our efforts tracking, taking just that group.

Senator DIXON. You tracked the 31 percent?

Mr. DODGE. Yes, we took the statistical sample of that 31 percent thinking that that would reflect some kind of a measure of the program's achievements to find out whether it did.

Senator DIXON. How did they do?

Mr. DODGE. Only 36 percent of those recorded as paid in full did we find actually had their doors open as ongoing businesses.

Senator DIXON. You are kidding.

Mr. DODGE. No.

Senator DIXON. If that were really true—let me pursue that just a moment, Mr. Dodge. You are saying that 39 percent are positively a failure.

Mr. DODGE. That is correct.

Senator DIXON. Of the 31 percent that got out of the system paid in full, you are saying that only 36 percent of them are still doing any good.

Mr. DODGE. That is exactly right.

Senator DIXON. So that two-thirds of those ended up not enduring as a going business.

If those figures are correct, you are saying to me that in fact 59 percent of the businesses that received EOL loans are failures, are you not? You see what I am saying? The 39 percent you acknowl-

edge, and then two-thirds of the 31 percent that you have pursued since are not doing any good. If you take that, you have got to add another 20 percent into the portfolio of failures. You are saying to me that approaching 60 percent of this whole operation has not succeeded in a long-term evaluation of them.

Mr. DODGE. And we think that is the way the program ought to be measured—in terms of what the results are downstream.

Senator DIXON. That is an even worse percentage than that suggested by the Globe-Democrat series—by far worse.

Mr. DODGE. Because we use a stricter measure of success. We believe that is really what the program should aim itself at—setting up businesses that are going to last and not strictly getting loans out. We think even the low failure rate look is relatively shortsighted compared to the notion of looking downstream to see what you have 5 or 10 years on in the way of results.

Senator DIXON. But notwithstanding that—and I am totally amazed by that figure—you feel that adoption of the proper criteria and correct safeguards in an approach to the situation that would highlight this seeking out of those that look to be the best opportunities for success would continue to insure the viability of the program?

Mr. DODGE. We are not prepared to say that if all of our recommendations were adopted that that would insure the program's success, if we could agree on what success is.

We think that the program has to be given a shot at operating with a new set of goals and with tightened up procedures before you can begin to draw your final conclusions.

Senator DIXON. Incidentally, your figures that we have discussed here are limited to the EOL program—the economic opportunity program?

Mr. DODGE. That is correct. They include both direct and guaranteed loan segments of that program.

Senator DIXON. May I observe that very shortly I have to go vote. I am not down to the five lights yet, but I will be in a moment.

I would like to ask you some more questions, Mr. Dodge, if I may, and your two colleagues. Then I believe Mr. Cardenas is here. I saw him earlier in the room.

I hate to keep a very busy man like you waiting so long, Mr. Cardenas. Can you tolerate my running off to vote and coming back if we then proceed to you when we complete this panel?

Mr. CARDENAS. No problem, Senator.

Senator DIXON. I want to apologize for the inconvenience, but I had better go vote. If you will all excuse me, I will be back in about 5 minutes. I thank you very much. We are temporarily recessed.

[Recess taken.]

Senator DIXON. I apologize for keeping you all waiting.

Mr. Dodge, I think the most important thing to be developed here is that aspect of your testimony regarding the methods in which this program can be substantially improved in the future.

There were three points that you made. I wonder if we could go into those. Would you begin with point one?

Mr. DODGE. We recommended that the first concrete step that SBA can and should take is to introduce more careful screening of applicants, by which we mean looking at the projections of cash

flows and expenses to see whether the promise of repayment is real—we heard this morning that is not always so—and to narrow and eliminate the waiting list which led to less qualified applicants getting the loans that better qualified applicants might otherwise have gotten.

Senator DIXON. I do not understand that part. I heard your testimony to that effect a moment ago, about the waiting list and how that tends to result in a lot of bad loans. I do not know if I understand that.

Mr. DODGE. Applicants, as they are deemed to cross a minimum threshold of eligibility, are put on the waiting list in chronological sequence. This is done by standard operating procedure. It is written in the SBA internal guidelines. That means that everybody who is eligible is on that list chronologically. Then, as loan funds become available, they just go down the list in the order that it appears.

Senator DIXON. Without regard to which is the better loan?

Mr. DODGE. Exactly. The result is that the good prospect low down on the list may not get reached until maybe 1 year or 15 months later, and by that time he may have changed his mind as to whether he wants to go into that business.

Senator DIXON. Your point is that they ought to evaluate everybody on the list and from those take the ones that are the better loans without regard to a chronologically advantageous position by one individual over another?

Mr. DODGE. Or, even better still, to elevate the initial eligibility threshold enough so that only good prospects ever make it onto the list. Then you would be working with a population where you would have better prospects of successful loans.

Senator DIXON. Is that policy now abandoned by the SBA as far as you know—the chronological list policy?

Mr. DODGE. We checked back within the last few weeks to those offices we initially surveyed. We found that, while the policy has not been abandoned, the lists are virtually nonexistent, as the result of changes that we have heard mentioned, and presumably we will hear more about later this morning, to improve or upgrade the eligibility criteria.

Senator DIXON. Is there anything else under No. 1 you want to say other than that?

Mr. DODGE. That is essentially it, unless my colleagues want to add anything.

Senator DIXON. What about No. 2.

Mr. DODGE. No. 2—and I am not setting these forth in exactly the same order that I did before, but we will wind up covering the same points—is to set up the loans so that the borrowers have a fighting chance.

The two subcomponents of that are first, to make sure that the loan amount which is set up is adequate. So often in our case studies we found that a lesser amount than was really required to make the business go was loaned by SBA. So in effect you could say the decks were stacked against the applicants before the loan even took effect.

The second part of that is getting management assistance out to borrowers earlier and more intensively.



We think that if those two steps were combined borrowers would have a much better chance than they might otherwise.

Senator DIXON. There seems to be a conflict in the testimony here about whether there really truly has been management assistance in the past. I got the impression Dr. Saigh felt in his case there had been, but I do not see too much evidence of it generally in what I have seen about the program.

Mr. DODGE. We have taken a sample, and we can provide for the record if it would be helpful, from that sample, how many actually received management assistance and at what stage.

Senator DIXON. What percentage did?

Mr. DODGE. Mr. Donaghy?

Mr. DONAGHY. Let me see if I can find that. It was less than half. It was 69 of the borrowers in a sample of 150 loans who got management assistance.

Senator DIXON. That was 69 out of 150—less than 50 percent.

Mr. DONAGHY. That is right. I would say that they were all offered the assistance, but only 69 took advantage of it.

Senator DIXON. Would that be the extent of it under No. 2?

Mr. DODGE. Yes.

Senator DIXON. And under No. 3?

Mr. DODGE. The third specific recommendation is that SBA should experiment with repayment arrangements that are more flexible than the ones that they have used. In particular, the one that we think has the most promise is a graduated repayment schedule which would go easy on repayments early on and then step up.

SBA has been reluctant to do that. It is a bit more complicated than the system that they had been using. SBA tends either to want to get payment or to defer rather than to get into more flexible arrangements.

We think that and the use of grace periods would make a measurable difference in the administration of the program.

Senator DIXON. I think it is fair to say that every one of the three things that you have recommended as improvements in the program are things that can be done under existing law internally by strengthening procedures within the agency. Would you say that is substantially true?

Mr. DODGE. We would. We have looked at the new language under the Budget Reconciliation Act, and we see nothing in that language that would not allow SBA to implement these recommendations.

Senator DIXON. Are there any legislative improvements that you can suggest to this committee for further consideration in the future?

Mr. DODGE. There is one that I think is worthy of attention, and that is to write more clearly or more explicitly into the overall objectives of the direct loan program the notion that it should be measured, not so much in terms of what happens to the loans—were they good or were they not good—but to look more downstream to find out whether the borrowers who got the loan established ongoing businesses.

I think that is the single most important thing that SBA could do to, in a sense, transform their goal structure from a short-range,



dollars-and-cents orientation to a longer-range, "Let's see what happens 5 years or 10 years from now" goal. That would in effect shift the context of the entire way that the program is set up to look toward positive results.

In my own view, I think that if that took place that would be the single most important change to take place; and it would certainly help to have legislative reinforcement of that change of perspective, if you will.

Senator DIXON. I would like to hear from you at your convenience sometime with what you could suggest as a possible course for us to follow.

Incidentally, one of the things that occurs to me in everything I have read and from what I hear here today is that at least in the past—and I do not mean this as a criticism of Mr. Cardenas or those who are running the agency now, because we are not current enough to really know this now—there was very little effort internally in the agency to train people within the agency about what they should be doing and to orient them toward the kinds of goals that the program ought to be seeking. Is that the evidence that you find in what you have looked at as well?

Mr. DODGE. I am not sure that I can say that we have addressed SBA's training specifically, but I think it is fair to say that we have not found reflected in the way they do business the goal orientation and some of the attitudes that you might expect to find with persons engaged in this program.

Senator DIXON. Do you have anything to add, Mr. Fricke, to what Mr. Dodge has said? Or do you, Mr. Donaghy?

Mr. FRICKE. Only, Senator, to add to what Lowell has said regarding the legislative possibilities—that perhaps the committee could be more explicit in terms of the types of businesses and specific goals they would like to see the program focus on. For example, perhaps greater emphasis should be placed on trying to direct loans more to job-creating types of businesses or innovative types of businesses, rather than the way it is presently done.

I am speaking not just about direct loans, but also about guarantee program as well. You may want to direct your attention to this matter.

Senator DIXON. I thank you.

Mr. Donaghy?

Mr. DONAGHY. I do not have anything further to add.

Senator DIXON. I want to say thank you to you all and to say further, Mr. Dodge, to you and your associates that anything that you can send along to us to elaborate upon what you have already given us in your written testimony, or anything in addition that you would like to add to the record, we will be delighted to have as we continue to review this program.

I think it is a fair evaluation of what you said—that you think that there is an opportunity for success within the framework of the program with the proper safeguards and the proper internal procedures to reevaluate the method in which this program should be operated within the agency.

Mr. DODGE. That is a fair summary, Senator.

Senator DIXON. I want to thank you all. I am going to call Mr. Cardenas now. Thank you very much for your testimony.

Mr. DODGE. Thank you.

Senator DIXON. Mr. Cardenas, before you start to testify, may I simply say that the committee may have additional questions for each of the witnesses who appeared here today. We will provide them to the witnesses and ask them to respond to the committee in writing.

Also, I do not want to inconvenience you, Mr. Cardenas, by keeping you here longer. We are going to recall Mr. Lump after a while to go into a few specific cases, I am now told he has with him, that we would like to evaluate. You might not want to stay for that, but I wanted you to know, that so that if anyone from your agency wishes to stay they will be welcome to.

Thank you, Mr. Cardenas.

Would the three of you mind standing and raising your right hands so we can swear you? Do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. CARDENAS. I do.

Mr. HOLLOWAY. I do.

Mr. HERTZBERG. I do.

Senator DIXON. Do you have a prepared statement, Mr. Cardenas?

Mr. CARDENAS. Yes, I do, Senator.

Senator DIXON. Thank you, please proceed.

**STATEMENT OF HON. MICHAEL CARDENAS, ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY EDWIN HOLLOWAY, ACTING ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT; AND CHARLES HERTZBERG, ACTING DEPUTY ASSOCIATE ADMINISTRATOR FOR FINANCIAL ASSISTANCE, SBA**

Mr. CARDENAS. Senator, I also have accompanying me Mr. Edwin Holloway who is the Acting Associate Administrator for Finance and Investment and Mr. Charles Hertzberg, Acting Deputy Associate Administrator for Financial Assistance.

Senator DIXON. We are glad to have you gentlemen here.

Mr. CARDENAS. Mr. Chairman, other Senators, and staff, it is a pleasure to appear before the Committee on Small Business to discuss the Small Business Administration's direct loan programs.

It should be made clear at the outset that the SBA direct loan program is, and always has been, limited to those borrowers that are unable to obtain loan assistance from private lenders. The Congress determined that SBA should act as a lender of last resort and therefore our portfolio is inherently more risky than that of private lenders.

From the inception of the agency through the midsixties, the direct loan program was the principal form of loan assistance made available by SBA.

In the sixties, national attention was focused on equal opportunity programs including assistance to minority businesses. These borrowers had greater difficulties in obtaining loans from private lenders, and there was increasing pressure to meet these needs through Government programs.

In the early seventies, as the loan programs grew in size and popularity, the agency's management placed a greater emphasis on

measuring accomplishments in terms of the number and dollar volume of loans made. As this emphasis grew more intense and staffing remained almost constant, there was a degree of softening in the general quality of loans approved.

The agency's default and loss rate started to climb, particularly in the economic opportunity loan program, and the agency attempted to determine, through the congressional hearing process, what an acceptable loss rate should be. The question of what is an acceptable default rate in a program which is designed to address social as well as economic needs is not easily answered. The increasing default and loss trends continued through 1980. Upon entering the agency, I concluded that such a trend would not continue.

A number of statutory and administrative actions taken this year will provide the framework for better control of our lending programs.

First, enactment of the President's budget cuts—Public Law 97-35—will substantially aid our efforts to better administer the direct lending program. Direct lending programs were cut 40 percent. While this means less lending for small business, it provides SBA with more time necessary to get our portfolio under control. Our personnel will be able to make better judgments on individual applications because of the more realistic case load.

Second, Public Law 97-35 increased interest rates on direct loans, currently at 15 $\frac{7}{8}$  percent, which will remove some demand that existed solely because of deep interest subsidies resulting in rates well below market rates.

Third, the reconciliation bill, by consolidating credit terms, provides one set of credit criteria for virtually all direct loan programs, removing the "softer" criteria that had been applied to the economic opportunity loan program.

At SBA we have changed the philosophy governing administration of all of our lending programs to emphasize the quality of loans versus quantity of loans. I believe we can emphasize quality and still fulfill our role as a lender of last resort.

By statute, we must require "reasonable assurance of repayment" on all loans. Unfortunately, this requirement had been subordinated to administrative considerations such as numerical goals and targeting. Reasonable assurance of repayment must be the overriding consideration.

We often are providing a valuable service to a potential business person when we say "no" to their loan request. We cannot continue in the business of allowing everyone the opportunity to fail at the taxpayers' expense.

To implement this new philosophy, the agency has taken the following steps:

All numerical goals in loan-making activities have been abolished.

We have determined that the principal objectives for agency loan-making staff upon which their performance will be measured are to sharply improve the quality of loan decisions and the timeliness of loan processing. This should counter the practice of "getting the money out" which has caused approval of some very bad loans.

In line with the President's initiatives, we have implemented a comprehensive debt collection plan to deal with the existing loan portfolio.

We are in the final stages of approving district and regional operating plans which incorporate this renewed emphasis on attaining qualitative objectives rather than quantitative budgetary goals.

Of course this type of guidance to the field takes time to implement. We must change the field perception of how our loan program should operate. I assure you I will reiterate at every opportunity with our field personnel the need to implement this new philosophy. In fact, yesterday I signed a memorandum to our field offices transmitting a copy of this statement and indicating how seriously I take implementation of these new initiatives.

Overall, these changes will provide a balance between providing economic assistance to small businesses which cannot obtain it from private sources and protecting the investment of the U.S. taxpayer. I believe this reflects the original intent of Congress and this agency's mandate.

Regarding our program loss rates, a principal reason for calling this hearing is the series of articles on the direct loan program published by the St. Louis Globe-Democrat. That series was based upon selected information obtained from SBA on 16 of our district offices together with interviews with some of our personnel. From that information, the series projected nationwide statistics.

I would like to comment on some discrepancies we have found in these projections through our own computer analysis of the nationwide portfolio. The series indicated that in the approximately 9 years covered by their analysis, national SBA losses have exceeded \$571 million. Our analysis indicates that in fact the newspaper's figure is more than twice the actual national figure. Further, of the 25.78 percent of dollars we show in default, 46.13 percent is found in the economic opportunity loan program, though that program accounts for only 33.2 percent of total dollar volume. It was anticipated some 15 years ago that the EOL program would have a default rate of between 35 and 50 percent.

Of course headlines which state "42 percent of SBA borrowers end up in default and out of business" can mislead the public and serve as an indictment of all SBA lending programs. No differentiation is made between direct loans and loans made in cooperation with banks. Taking into account all of our lending programs, the ultimate loss rate is anticipated to be 8.06 percent, based on September 1980 figures.

Rather than outline the findings of the St. Louis articles item by item, we have prepared and attached to this statement a breakdown of specific findings with our responses to be included in the record.

My conclusions are that many questions remain to be answered concerning the future direction of SBA's lending programs, particularly in the direct lending, and I pose these questions:

First: What is the best method for distributing limited loan resources?

Second: Should we restrict direct loans to \$50,000 rather than \$150,000 to assist a greater number of businesses?

Third: Should we target assistance to certain industry groups? Innovative firms? Small exporters?

Fourth: Should we continue a program which only assists 2,500 to 3,000 firms a year?

Fifth: What implications do our decisions concerning the direct loan program have for the future allocation of resources and the mission of the Small Business Administration?

These are not easy questions to answer. We look forward to working with this committee and your House counterpart in determining the answers to these and other issues in direct lending.

This concludes my prepared remarks. I will be happy to answer any questions you might have.

Senator DIXON. Thank you, Mr. Cardenas.

Without objection, the attachment to your statement will be included at this point.

[Material follows:]



## ADDENDUM TO STATEMENT

Senate Committee on Small Business  
Hearing on Direct Loan Program

October 27, 1981

In August and September of this year the St. Louis Globe Democrat ran a series of articles on the SBA Direct Loan Program.

The information contained in that series was based upon data provided by SBA on the Direct loan program covering sixteen specific field offices during the period from 1970 through 1978. From an analysis of the information provided, the series drew conclusions about the program as carried on across the entire nation.

In preparation for this hearing, the Agency made a similar analysis to that of the newspaper, but covering the entire nation, and, where deemed appropriate, made further analysis to verify or refute the conclusions drawn.

Set forth below is a summary of SBA's analysis:

16 Offices (Dollars in Millions)

| Disbursements |               | Defaults      |               | % of Defaults |               |
|---------------|---------------|---------------|---------------|---------------|---------------|
| <u>Number</u> | <u>Dollar</u> | <u>Number</u> | <u>Dollar</u> | <u>Number</u> | <u>Dollar</u> |
| 14,261        | 473.1         | 5,948         | 157.5         | 41.7          | 33.3          |

All Offices (Dollars in Millions)

| <u>Disbursements</u> |               | <u>Defaults</u> |               | <u>% of Defaults</u> |               |
|----------------------|---------------|-----------------|---------------|----------------------|---------------|
| <u>Number</u>        | <u>Dollar</u> | <u>Number</u>   | <u>Dollar</u> | <u>Number</u>        | <u>Dollar</u> |
| 46,603               | 1,482.6       | 18,116          | 382.3         | 38.9                 | 25.8          |

In preparation for the series, the newspaper staff obtained from SBA a report of national direct loan approvals for the same period as their study. That figure totalled \$1,715.4 million. In the body of the series, they stated that the "direct business loan program from 1970 through 1978 (has) cost the federal Treasury \$571,228,200 - a figure that could reach \$900 million if losses in 1979 and 1980 are consistent with previous years."

Although the newspaper staff advised Agency personnel that their definition of default was those loans in liquidation and those charged-off, they used the percentage of dollar default (33.3%) applied to total direct loan approvals (\$1,715.4 million) to arrive at a loss figure of \$571,228,200. This careless use of terminology results in a 100 percent exaggeration of Agency overall direct loan losses. The actual loss figure is \$263,867,340 plus interest charge-offs of \$22,352,200 for a total of \$286,219,540, or 19.3 percent of disbursements for the period (less modest recoveries after charge-off).

Further imprecise headline statements made it appear to the casual or unformed reader that such default rates applied to all programs rather than just direct loans.

Such characterizations are less representative when it is recognized that the direct loan program defaults and losses were not broken down to their component programs.

One further point must be addressed from a statistical standpoint. The series concluded from their analysis and a study of loans by Zip Codes that loans made in traditional white areas averaged 41.1 percent more than loans made in traditional minority areas, inferring a pattern of underfunding of minority loans contributing to a higher failure rate.

This inference is incorrect most likely resulting from a lack of understanding of the programs they were attempting to analyze.

The bulk of the number of direct loans made, over 60 percent, were made under the Economic Opportunity Program. Further, approximately 79 percent of the loans made under the EOL program were made to minorities.

Not only did the EOL program have a lower statutory limit on the amount of loan, but such loans were primarily made to smaller or start-up businesses which had more modest financial requirements.

In examining the amounts of loans made to minorities and non-minorities under both the 7(a) and EOL programs, we found the following:

Average Dollar Amount of Loans for  
the Period of Study

|      | <u>Number of<br/>Loans</u> | <u>Average Loan<br/>Size (minority)</u> | <u>Number of<br/>Loans</u> | <u>Average Loan<br/>Size (Non-minority)</u> |
|------|----------------------------|-----------------------------------------|----------------------------|---------------------------------------------|
| 7(a) | 5,193                      | \$ 42,634                               | 10,309                     | \$ 41,827                                   |
| EOL  | 22,218                     | 17,505                                  | 5,985                      | 17,314                                      |

Actually, the average size of loans made under each program to minorities was larger than those made to non-minorities.

SBA Analysis (Nationwide)  
(Dollars in Millions)

| <u>Program</u> | <u>Disbursements</u> |               | <u>Defaults</u> |               | <u>% of Default</u> |               |
|----------------|----------------------|---------------|-----------------|---------------|---------------------|---------------|
|                | <u>Number</u>        | <u>Dollar</u> | <u>Number</u>   | <u>Dollar</u> | <u>Number</u>       | <u>Dollar</u> |
| 7(a)           | 15,502               | 652.6         | 4,709           | 161.5         | 10.1                | 10.8          |
| EOL            | 23,203               | 492.6         | 12,924          | 176.0         | 27.7                | 11.8          |
| DCL            | 2,714                | 313.6         | 469             | 43.1          | 1.0                 | 2.9           |
| HAL            | 215                  | 24.8          | 15              | .9            | -0-                 | .1            |
| Grand Ttl*     | 46,634               | 1,483.6       | 18,117          | 385.1         | 38.8                | 25.7          |

\*Slight variation from summary

Percentages by Program

| <u>Program</u> | <u>Disbursements</u> |               | <u>Defaults</u> |               |
|----------------|----------------------|---------------|-----------------|---------------|
|                | <u>Number</u>        | <u>Dollar</u> | <u>Number</u>   | <u>Dollar</u> |
| 7(a)           | 33.2%                | 44.0%         | 26.0%           | 42.3%         |
| EOL            | 60.4%                | 33.2%         | 71.3%           | 46.1%         |
| DCL            | 5.8%                 | 21.1%         | 2.6%            | 11.3%         |
| HAL            | .5%                  | 1.7%          | .1%             | .2%           |

Percentages of Total Disbursements and Defaults  
(Combined Programs)

|                    | <u>Disbursements</u> |               | <u>Defaults</u> |               |
|--------------------|----------------------|---------------|-----------------|---------------|
|                    | <u>Number</u>        | <u>Dollar</u> | <u>Number</u>   | <u>Dollar</u> |
| Minority Loans     | 60.5%                | 47.2%         | 43.4%           | 32.6%         |
| Non-Minority Loans | 39.5%                | 52.8%         | 31.9%           | 19.5%         |

SBA DEFINITION OF TERMS

CHARGE-OFF - An accounting transaction removing an uncollectible balance from the active receivable accounts.

CHARGED OFF LOAN - An uncollectible loan for which the principal and accrued interest were removed from the receivable accounts.

DEFAULTS - The nonpayment of principal and/or interest on the due date as provided by the terms and conditions of the note. Defaults also occur in rent payments under Lease Guaranty and/or failing to complete contracts guaranteed by Surety Bond Program.

DEFERRED LOAN - Loans whose principal and or interest installments are postponed for a specified period of time.

DEVELOPMENT COMPANY LOANS - Loans under Sections 502 and 501 local or state development companies for use in implementing the planned economic growth of communities by promoting and assisting the growth and development of small business concerns in the area under Section 502. SBA may lend up to \$500,000 for up to 25 years for each small business to be assisted by a local development company project.

DIRECT LOAN - Loan made solely by SBA utilizing government funds. 7(a) limited administratively to \$150,000 (by statute \$350,000); EOL by statute to \$100,000.

ECONOMICALLY OR SOCIALLY DISADVANTAGED - Whether one is economically or socially disadvantaged is based on the composite of several factors; which may include membership in a racial minority; low income; geographic location, e.g., urban ghettos, depressed rural areas; limited education; and other handicaps.

ECONOMIC OPPORTUNITY LOAN - Loans to socially or economically disadvantaged persons who are current or prospective small business owners. The maximum amount of an EOL is \$100,000 for up to 15 years.

LIEN - A charge upon or security interest in real or personal property maintained to ensure the satisfaction of a debt or duty ordinarily arising by operation of law.

LIQUIDATION - The disposal, at maximum prices, of the collateral securing a loan, and the voluntary and enforced collection of the remaining loan balance from the obligors and/or guarantors, by SBA Portfolio Management Specialists.



LIQUIDATION VALUE - The net value realizable in the sale (ordinarily a forced sale) of a business or a particular asset.

LITIGATION - Refers to a loan in "liquidation status" which has been referred to SBA Counsel (and often on to the U.S. Attorney) for legal action.  
Also: The practice of taking legal action through the judicial process.

LOSS RATE - A rate developed by comparing the ratio of total loans charged off to the total loans disbursed from inception of the program to the present date.

MINORITY (02) - Program category classification code covering all assistance of any type made to promote minority entrepreneurship (small business or Local Development Companies (LDC), with 50 percent or more ownership by minorities). Minority classifications include Blacks, Puerto Ricans, American Indians, Hispanics, Asians, Eskimos/Aleuts. This code is reflected in Item 4 of SBA Form 135, Loan Approval Document. Refer to SOP 20 20 for detailed explanation.

MINORITY CODES - A numerical system employed for measuring agency assistance provided to various classifications of recognized Minority groups. Collected for statistical purposes only, though various reporting systems in SBA.

|      |   |                                                                                                                                                       |
|------|---|-------------------------------------------------------------------------------------------------------------------------------------------------------|
| Code | 0 | Blacks                                                                                                                                                |
|      | 1 | Puerto Ricans                                                                                                                                         |
|      | 2 | American Indians                                                                                                                                      |
|      | 3 | Hispanics (includes Mexican Americans, Cuban, Central or South American, or other Spanish descent)                                                    |
|      | 4 | Asians (includes persons of Chinese, Japanese, Korean and Filipino descent, also native Hawaiian, Indonesians, Samoans, Polynesians and Micronesians) |
|      | 5 | Eskimos and Aleuts                                                                                                                                    |
|      | 6 | Undetermined                                                                                                                                          |
|      | 7 | Others - including whites                                                                                                                             |

NEW OR EXISTING BUSINESS - For 7(a), EOL and DCL loans, a new business is one in operation for 180 days or less. The acquisition of a business which has already been in existence over 180 days constitutes an "existing" business.

PORTFOLIO (OR TOTAL LOANS OUTSTANDING) - The outstanding principal amount of all active loans containing a principal balance (current, past due, delinquent and in liquidation) owed to SBA and participating banks. This includes guaranteed loans. Depending on use, can be expressed in terms of the total amount or the SBA share. Ordinarily, the term "portfolio" refers only to the SBA share (loss exposure) of outstanding loans.

SUBORDINATION AGREEMENTS - Agreements between SBA and lien holders under which the priority of claims is modified.

327 ACTIONS - All modifications of loan terms and conditions, or administrative actions on specific loan accounts are accomplished by use of SBA Form 327. This document is used in the automated loan accounting system.

Senator DIXON. I want to thank you for coming in here today and giving us the benefit of your point of view.

May I say at the very outset that we would be very appreciative—those of us on the committee—if you would convey to us at your convenience any suggested legislative responses to the problems in the direct loan program of the SBA. Would you be kind enough to do that after you and your staff have given it careful thought?

Mr. CARDENAS. Definitely, Senator.

Senator DIXON. Further, if I could pursue something with you I mentioned earlier to other witnesses. It occurs to me, in connection with what I have read and what I have heard here, that there has not been much internal past effort in the field to train agency personnel concerning this program; to let the people know exactly what you and others at the top expect of them in respect of this program. Would you say that is a fair analysis of what has occurred in the past?

Mr. CARDENAS. Well, it appears that that has occurred; but I think perhaps our field operations review in the past has not really reviewed that process. Whatever direction they were directed, they should have been held accountable for it. Certainly this is something that our new field operations will be reviewing very critically.

Senator DIXON. I would like to suggest to you that I think it would be very much in the interests of the country and this program if you would have regional meetings of your personnel and send out to the regions some of your top people to go into detail with them about what this program's procedures will be in the future—what your reasonable expectations are, your goals, and so forth—and have question and answer periods and work with these people. I think it would help a great deal.

Mr. CARDENAS. There is no question about it, Senator. They will, and we are patiently waiting to get all our regional administrators on board to really go out to the field. They will have specific directions.

In the meantime, my staff in the central office have well directed the people in the field, but I think it will help once we have our

regional administrators on board. I am hoping and planning that they will be on board by the end of this month.

Senator DIXON. I thank you for that.

You also heard Mr. Dodge's testimony. I would like to recommend to you that those in the staff be directed to follow the recommendations given in that testimony if you concur in what was said by Mr. Dodge.

Mr. CARDENAS. For the most part, yes.

Senator DIXON. That is to say those three points that he very explicitly made in the course of his testimony and in the question and answer period. Was there anything about that that you took issue with at all?

Mr. CARDENAS. No, sir.

Senator DIXON. One of the things that did come up that I think everyone is concerned about with reference to the treatment of those loans is the chronological list. The suggestion has been made that that has already been abandoned. I would hope it is clear in the field that that has been abandoned.

Mr. HOLLOWAY. Senator, we have not really abolished so far the idea that says that it is generally first come, first served. But what has really changed is the idea of accommodating the credits that have a reasonable assurance of repayment and not subordinating that to any other consideration, specifically the consideration of a numbers game of how many loans can we make.

Senator DIXON. Very good.

Would you mind giving me your name and title for the record?

Mr. HOLLOWAY. I am Edwin Holloway, the Acting Associate Administrator for Finance and Investment.

Senator DIXON. I thank you, Mr. Holloway.

One thing on which I suppose there continues to be a difference of opinion is the default rate on these loans. Mr. Cardenas, I have here a report given me by the Senate Committee on Small Business staff concerning this whole question for the fiscal years 1970 through 1978—the SBA direct loan defaults—which would seem to show that throughout that period there were 46,634 loans involving \$1,483,517,000, of which 18,117 are in default, amounting to \$381,500,000, a percentage of default in numbers of 38.8 and in amounts of 25.7.

They further indicate that, of the loans, there was a minority total of 28,223 involving \$700,606,000, and that of those 28,223, 12,235 are now in default, involving \$228,481,000, or a percentage default in numbers in 43.3 and in amounts of 32.6.

Are those figures meaningful to you? Do you have anything similar to that available?

Mr. HOLLOWAY. Senator, there is no question but what those figures validly indicate that our loanmaking quality standards have not been sufficiently high.

I think the general methodology employed by the reporters in the St. Louis series of articles was for the most part valid, and we made our analysis to be consistent with the approach they used for comparison purposes.

Senator DIXON. I appreciate your saying that. While I do not want to be argumentative about it—and I say this most respectfully of you, Mr. Cardenas—I have not seen any figures that would

quarrel too much with the figures used in that article on the basis of what staff has given me and even on the basis of our respected friends who constituted the previous panel.

Mr. HOLLOWAY. I must say, Senator, that the one piece of the approach that could be misleading is the adding together of all the loans in liquidation with charge-off amounts which are clearly losses. Of the amount in liquidation, the agency does recover about 48 percent, such that to count all of the loans in liquidation as being losses is not technically correct in a loss sense.

However, I believe the GAO point was very fair—that down the road, to look at the continued existence and success of the business is to a degree what SBA is all about, equally as much as whether or not a loan is paid in full.

Senator DIXON. I appreciate that. I appreciate your comments.

I take it from what you have said that you do not have too much quarrel with the staff's report here on what their figures indicate. If you do not, I believe we will incorporate that in the record. That is from your own computer printout, as a matter of fact, of October 20, 1981.

Mr. HOLLOWAY. It may be. We have no objection to the information as reflected on the computer printout if a special analysis or an array of that has been done. I would appreciate an opportunity to see it before going on the record and confirming that I fully agree with it.

Senator DIXON. Mr. Chvotkin will hand that to you.

Mr. HOLLOWAY. If we may submit for the record, after an opportunity to look at this, Senator—I believe it does accurately reflect just a different array of what our computer information shows.

Senator DIXON. Yes. May I quote this to you in all due respect? Staff says to me that they are somewhat confused and strongly urge the agency to carefully document their definitions and during the next 2 weeks meet with committee staff and try to arrive at a jointly acceptable set of definitions and assumptions.

I would say that that is the staff's best analysis of the computer printouts from your agency. If you have any difference with those figures, we would appreciate you conferring with our people about that.

Mr. HOLLOWAY. I do not have any problem with that. I agree with you, Senator, that there has been an interchangeable use of a lot of terms that simply are not the same, such as failure rate, default rate, delinquency rate, liquidation rate, trouble rate, and really its losses ultimately are the success or failure of a business.

Senator DIXON. Yes. I think what we are going to do is put that analysis in the record, Mr. Holloway, subject to the right of you, Mr. Cardenas, and others in the agency, to meet with staff here. If you feel that there is anything that should be corrected, we would be delighted to give you every opportunity to make the record clear to reflect your point of view.

Mr. CARDENAS. Senator, I think this is a proper direction to clarify the glossary of the terms that we intend to use in our communications and supporting reports because, as was alluded to earlier by the mention of a 60-percent ratio, if you start mixing apples with oranges and mixing, say, direct loans with EOL loans, I think you are not keeping the figures in true perspective. This in

turn leads to a lot of additional ill publicity which we hope to correct.

Senator Dixon. Sure. I appreciate that.

[Material follows:]



## Fiscal Year 1970-1978 -- SBA Direct Loan Defaults \*

| FY              | Loans Disbursed |                 | Default Loans |               | Percentage Defaults |         |
|-----------------|-----------------|-----------------|---------------|---------------|---------------------|---------|
|                 | No.             | Amount          | No.           | Amounts       | Nb.                 | Amounts |
| 1970            | 3290            | \$73,603,000    | 1483          | \$19,630,000  | 45.0                | 26.6    |
| 1971            | 4538            | 88,844,000      | 2155          | 26,157,000    | 47.4                | 29.5    |
| 1972            | 6365            | 125,393,000     | 2954          | 36,256,000    | 46.4                | 28.9    |
| 1973            | 6052            | 155,715,000     | 2717          | 47,976,000    | 44.8                | 30.8    |
| 1974            | 4091            | 120,874,000     | 1585          | 33,769,000    | 38.7                | 27.9    |
| 1975            | 4478            | 162,606,000     | 1496          | 36,302,000    | 33.4                | 22.3    |
| 1976            | 5535            | 208,655,000     | 1871          | 49,620,000    | 33.7                | 23.7    |
| 1976            | 1297            | 45,570,000      | 449           | 12,664,000    | 34.6                | 27.7    |
| 1977            | 5476            | 232,188,000     | 1784          | 56,931,000    | 32.5                | 24.5    |
| 1978            | 5510            | 270,365,000     | 1623          | 62,190,000    | 29.4                | 23.0    |
| Totals          | 46,634          | \$1,483,517,000 | 16,117        | \$381,500,000 | 38.8                | 25.7    |
| Minority Totals | 28,223          | 700,606,000     | 12,235        | 228,481,000   | 43.3                | 32.6    |
| Non-Min. Totals | 18,411          | 782,911,000     | 5,882         | 153,019,000   | 31.9                | 19.5    |

\* Based on Senate Committee on Small Business Staff transposition of SBA-prepared computer printout Oct. 20, 1981

Senator DIXON. May I say further in connection with what you have just said that, obviously, Mr. Cardenas, you are new in the job; and the things we are discussing here do not reflect upon you or your administration of this agency.

We hope that we are doing something here that will create the kind of attitude here on the Hill that will encourage you to strengthen this program and make it a viable one that will work in the future. The program is not going to endure if it is not better operated than it has been in the past. It is just that simple.

Mr. CARDENAS. That is right. I just want to restate that I have always been and will always be an advocate and the advocate for the small business community. I have all the faith in the Small Business Administration to be able to foster this benefit for the small business community.

I look at our role as assisting those that want to help themselves, being the coordinators of some solid management assistance, and bringing the private sector in to play a very important role in their respective communities.

Senator DIXON. Let me just say on behalf of the committee that we appreciate your candor and your kindness in coming here and spending a morning with us once again, to attempt to improve these programs.

If you have any further information you would like to bring to the committee, either through Chairman Weicker, our ranking member Senator Nunn, or myself, we would be delighted to have the information in the future, particularly anything you might have in the way of recommendations for anything that can be done legislatively to strengthen or help this program and protect the interests of the taxpayers of the country.

Thank you very much, Mr. Cardenas.

Mr. CARDENAS. Thank you, Senator, for inviting us.

Senator DIXON. Thank you all.

We are now going to recall Mr. Lump, and then this hearing will recess until further notice of the Chair.

Mr. Lump, would you mind coming back?

Mr. LUMP. Not at all.

Senator DIXON. You are the same Bernard E. Lump who previously testified?

Mr. LUMP. I am really Bernard D. Lump.

Senator DIXON. Well, we will find out who made that mistake and take the appropriate action. Let the record show you are Bernard D. Lump and not Bernard E. Lump.

You have been previously sworn, Mr. Lump; and you are still under oath, of course.

Mr. LUMP. Yes.

Senator DIXON. It has been suggested that you have some specific files with you that may bring to the attention of this committee some of the problems in the program in the past as you personally experienced it in your own situation. Is that true?

Mr. LUMP. That is true.

Senator DIXON. Feel free to go ahead and elaborate on what you have there.

Mr. LUMP. Some of this should help you to understand the numbers. These are the incidents behind the numbers.

GAO said we had over a 50-percent failure rate—over 50 percent of the businesses were not operating after their investigation. I can show you why. We have two cases here.

In one of them, he was a minority construction foreman and his wife was a nurse back in 1972 when the loan was approved. They had a combined income of \$24,000; they were doing quite well. He wanted part of the "dream." He wanted to open a liquor store.

We approved a \$47,000 direct loan and took as collateral an investment house he had—a rental house—and his personal residence.

He ran into troubles right away. He never made a repayment. He eventually had to go bankrupt, and he lost the investment house in the bankruptcy. The chattels of the business were sold.

After the bankruptcy, as he was discharged as bankrupt, he had his house because the court abandoned it; there was no equity for the bankruptcy court. So it is in our liquidation portfolio now, and my loan officer wants to know what to do.

The only alternative we have is to foreclose on his house. He is currently an underemployed painter. The construction industry is not what it was. His wife is still a nurse, and they have a small income, but not enough to repay us over time.

This will be a paid-in-full loan. There has not been a business for over 6 years.

Does that help to explain to you why we have so many paid-in-full's and so few existing businesses?

Senator DIXON. That is in the file as a paid-in-full loan?

Mr. LUMP. It will be, once we foreclose and we collect the full amount of the loan.

Senator DIXON. But the business is a failure?

Mr. LUMP. Long ago. And this is not an unusual case. These are just cases that I reviewed last week.

Senator DIXON. OK.

Mr. LUMP. We have another one sort of like this one where we made a loan to a retired Air Force colonel. He went into the aircraft repair and flight-training business at an airport. He received a bank-guaranteed loan of \$125,000 in the early part of 1975. As collateral, we took the chattels and his personal residence, which is now appraised at half-a-million dollars; then it was about \$200,000.

The business did not work. He was undercapitalized.

Senator DIXON. What kind of business was it?

Mr. LUMP. Aircraft repair and flight training.

We made a direct loan in 1976, because of most of his claims of being undercapitalized. The direct loan was for \$220,000.

It still did not work. There was never a repayment on either loan. He went into bankruptcy also. The chattels were sold; the business equipment was sold for approximately \$69,000 and applied against the first loan—the bank loan.

Again, we have no alternative but to foreclose on his house. He has listed his house at \$590,000 and has received several offers at \$500,000 but is not inclined to take them because he would not receive any money; it would all go to the agency. We have started a foreclosure on his house.

This should culminate in two paid-in-full loans—two success stories.

Senator DIXON. That again is going to be a paid-in-full loan.

The point you are making in both those cases is that those paid-in-full loans, as they call them, go into the record as success stories.

Mr. LUMP. That is right.

Senator DIXON. But they are two obvious failures.

Mr. LUMP. They should be counted in a default rate. Our failure rate is based on dollars, and they are not businesses that are operating.

Senator DIXON. They are not only failures, but they are people who had some money and some property beforehand who are broke now. Is that right?

Mr. LUMP. That is right. It is very usual. These are cases that I have seen in my 9 years with the agency at all the offices; they are not unusual cases.

I lumped into three categories: The quasi-success stories——

Senator DIXON. Those are the quasi-success stories?

Mr. LUMP. Well, they will turn into that as far as the numbers go. GAO will pick them up as paid-in-full loans once the foreclosures are over, but nowhere will they show as a default once the foreclosures are terminated.

Senator DIXON. Of course I think GAO, in all fairness to them, has made the point that they are reviewing these. I think it was Mr. Dodge's testimony here that you do not just look at the defaults; you also go into the question of those that are not shown in that respect but are since out of business, notwithstanding the fact that they did pay the agency.

Mr. LUMP. Or they were forced to pay, more likely.

Senator DIXON. Sure.

Mr. LUMP. I agree with the GAO way of looking at it. It is between 50 and 60 percent for all loan programs. We do not have statistics that measure it, but my gut feeling is that you would find it to be over half.

Senator DIXON. Do you mean all or just EOL loans?

Mr. LUMP. I mean all.

Senator DIXON. You mean direct and guaranteed?

Mr. LUMP. I do.

Senator DIXON. What other files do you have there that you want to bring to our attention?

Mr. LUMP. The other ones I have are the ones without the large amounts of collateral. We have one where we had a minority lady working in an apparel store that the owners were trying to sell. They approached her with it. There are a series of financial statements that show you that the net profit has been dwindling. It is downtown Oakland, a deteriorating area.

We approved a loan in April 1980 for \$66,000 without looking at the assets of the business. We just looked at the financial statements. This is usual. Nobody went out to check the inventory. We disbursed \$11,000 for machinery, equipment, furniture, and fixtures; \$25,000 for existing inventory; \$11,000 to pay delinquent accounts receivable; and \$9,000 working capital.

She had to have been turned down by a bank, and she was. The turndown stated that she lacked a secondary repayment source. She had no backup. If the business did not work, she was going to go out quickly. And the projections appeared overstated.

We disbursed the loan in August 1980. Three months later she needed an additional \$10,000. Naturally, she did not make a payment for 3 months. We disbursed it.

It turned out that the expenses were understated, and 4 months later she filed a chapter 13—another bankruptcy. There were no payments but a threatening letter to sue us if we did not approve another package.

Senator DIXON. You said in the course of your testimony there that nobody went out and checked the business or anything.

Mr. LUMP. In the Liquidation Division we looked at the collateral that was selling—less than \$500 worth of inventory.

Senator DIXON. But I mean at the time the loan was made.

Mr. LUMP. No one looked.

Senator DIXON. Did I understand you to say that that is usually the way it is done—that nobody goes out and looks?

Mr. LUMP. Presently we are supposed to make visits on direct loans. This was over a year ago.

Senator DIXON. Has that changed now?

Mr. LUMP. It has. That one procedure has changed. The financing loan officer—the loan officer that recommends approval—now has to go out. But he can waive that if there is a large caseload.

Senator DIXON. Is there any other case there that you want to talk about?

Mr. LUMP. One more. This disturbs me and the staff. This accounts for about 20 to 25 percent, according to our district counsel, of all direct loans.

This was a loan made to a Jamaican noncitizen to open up a retail ice cream facility in an upper-middle income area. Again, there was no field visit. We disbursed \$30,000 approximately 9 months ago. Three months thereafter, he defaulted and called us and said he was abandoning it. He never made a rental payment. He filed for bankruptcy and went out of business.

We also checked with INS—the Immigration and Naturalization Service. When I opened the case, I had to do something. There was no indication if he was a legal alien or not; there was just an alien number as usual. I called them, and they said he was supposed to be in Baltimore. So we made a loan to an illegal alien.

Senator DIXON. What did you mean when you said this is about 25 percent of your cases?

Mr. LUMP. Twenty-five percent of our direct moneys are lent out to noncitizens—20 to 25 percent—in our office in San Francisco. I talked to Taylor Larimore, and he said it is similar in the Miami office.

Senator DIXON. So 25 percent of your loans are made to people who are not citizens of this country?

Mr. LUMP. Correct. I would not be able to guesstimate for the guarantee program.

Senator DIXON. Incidentally, did you hear all this testimony about the chronological list?

Mr. LUMP. Yes, I did.



Senator DIXON. What is your attitude about that? At least that is undergoing a change now.

Mr. LUMP. It is pretty much the same as it has always been. You apply, and you wait in line for the districts to receive funds. My attitude is that that is not the way you lend money. You lend it to your best cases. We just do these things bureaucratically instead of sensibly.

Senator DIXON. You have not loaned to your best cases in the past—that is what you are saying to me—you have done it pretty much on a chronological basis. You make the list, and then as the money comes in you make the loan.

Mr. LUMP. That is right. Worse than that is that we make the loans to whomever walks in the door. We do not go out and prospect for good clients, as other credit institutions would.

Senator DIXON. Do you really think your figure is correct on the percentage of loans that are made to noncitizens—that it is really that high?

Mr. LUMP. I am certain it is correct in San Francisco, because I asked the district counsel there. He oversees closing on all the direct loans. He did a sampling of his pending case files, and that is what it came to be.

Senator DIXON. OK. I want to thank you, Mr. Lump.

We may be sending you, Mr. Larimore, Mr. Dodge, and other witnesses here today some additional questions. We would appreciate your answers to those questions within a reasonable period of time.

Mr. LUMP. Thank you. I will.

Senator DIXON. Thank you for coming here today. ●

This hearing stands in recess until further notice of the Chair.  
[Whereupon, at 12:30 p.m., the hearing was recessed, subject to the call of the Chair.]

